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No.

IN THE

Supreme Court of the United States

CAPITAL ONE BANK (USA), N.A.,
F/K/A CAPITAL ONE BANK, AND CAPITAL ONE, N.A.,
AS SUCCESSOR TO CAPITAL ONE F.S.B.,

Petitioners,

v.

COMMISSIONER OF REVENUE OF MASSACHUSETTS,

Respondent.

On Petition For A Writ Of Certiorari To The Supreme Judicial Court Of Massachusetts

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

In *National Bellas Hess, Inc.* v. *Department of Revenue*, 386 U.S. 753 (1967), and *Quill Corp.* v. *North Dakota*, 504 U.S. 298 (1992), this Court held that the Commerce Clause does not permit a State to impose a sales or use tax on out-of-state corporations that have no physical presence in the State, because such corporations necessarily lack the "substantial nexus" with the taxing State that is a constitutional prerequisite to the exercise of the State's power to tax the business activities of such out-of-state corporations. The question presented is:

> Whether the Supreme Judicial Court of Massachusetts erred in holding that a State may evade the "substantial nexus" requirement as explicated in *Quill* and *Bellas Hess* by imposing an income or excise tax on the very same out-of-state corporations that are constitutionally immune from sales and use taxes because they lack a physical presence in the taxing State.

PARTIES TO THE PROCEEDING AND RULE 29.6 STATEMENT

The parent company of petitioner Capital One Bank (USA), N.A. (formerly known as Capital One Bank) and petitioner Capital One, N.A. (the successor by merger to Capital One F.S.B.) is Capital One Financial Corporation, a publicly-traded corporation. There is no other publicly-held corporation that owns 10 percent or more of the stock of either petitioner.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Page(s)

CASES

CONSTITUTIONAL PROVISIONS

STATUTES

RULES

OTHER AUTHORITIES

PETITION FOR A WRIT OF CERTIORARI

Capital One Bank (USA), N.A., formerly known as Capital One Bank, and Capital One, N.A., as successor to Capital One F.S.B., respectfully petition for a writ of certiorari to review the judgment of the Supreme Judicial Court of Massachusetts.

OPINIONS BELOW

The opinion of the Supreme Judicial Court of Massachusetts (App. 1a-22a) is reported at 899 N.E.2d 76. The opinion of the Appellate Tax Board (App. 23a-53a) is not published but is electronically reported at 2007 WL 1810723.

JURISDICTION

The judgment of the court below was entered on January 8, 2009. The jurisdiction of this Court is invoked under 28 U.S.C. § 1257(a).

CONSTITUTIONAL PROVISION INVOLVED

The Commerce Clause provides:

> The Congress shall have Power . . . To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes.

U.S. CONST. art. I, § 8. The pertinent Massachusetts statutory provisions are reprinted in an appendix to this petition. App. 54a-69a.

STATEMENT

This case presents a recurring question of extraordinary significance to the Nation's economy. Notwithstanding this Court's holdings in *National Bellas Hess, Inc.* v. *Department of Revenue*, 386 U.S. 753 (1967), and *Quill Corp.* v. *North Dakota*, 504 U.S. 298 (1992)—namely, that the "substantial

nexus" required by the Commerce Clause is absent when a State attempts to impose sales or use taxes on out-of-state corporations that have no physical presence in the State—a number of state appellate courts (including the Supreme Judicial Court of Massachusetts (SJC) below) have now held that States may easily evade that constitutional prohibition through the simple artifice of taxing the same economic activities by means of income or excise taxes instead of sales or use taxes. Growing numbers of state legislatures and tax collectors have chosen to follow that same course. The resulting heavy burdens on interstate commerce and disincentives for economic activity that reaches across state lines will continue to worsen absent this Court's intervention. Certiorari is warranted to ensure that the principles enunciated in this Court's decisions are not flouted by revenue-greedy States to the detriment of interstate business activities and, ultimately, the Nation's economy as a whole.

Further review is necessary in this case, for three reasons. First, the decision below is fundamentally inconsistent with this Court's explication of the "substantial nexus" requirement in *Quill*. That case reaffirmed the physical-presence requirement and held that a business "whose only contacts with the taxing State are by mail or common carrier lacks the 'substantial nexus' required by the Commerce Clause." 504 U.S. at 311. To be sure, *Quill* construed the "substantial nexus" requirement in the context of a use tax, but there is no principled basis for applying a different constitutional rule to other types of taxes so far as "substantial nexus" is concerned. The physical-presence requirement should govern the income tax at issue here, and there is no warrant for the SJC's contrary conclusion.

Second, the decision below sharpens a conflict among state appellate courts over state authority to tax out-of-state corporations with no in-state physical presence. While the SJC joins state courts that have artificially constricted *Quill* to the sales-and-use-tax context and adopted a vague economic-nexus approach for income taxes, other appellate courts have correctly understood *Quill* as a binding interpretation of the "substantial nexus" requirement that is fully applicable to income and excise taxes. The unacceptable result of that growing discord is that the meaning of the Federal Constitution shifts as business activity crosses borders, from States that respect physical presence to those that do not. This Court's review is necessary to resolve that conflict.

Finally, the decision below intensifies the already enormous practical difficulties that multistate businesses confront in ascertaining and satisfying their tax obligations to States with which they have no tangible connection. The problems posed by state departures from the physical-presence requirement have grown more severe since the last time this Court considered the issue two years ago, and indeed have been exacerbated by this Court's denial of review at that time. The time to decide the scope of *Quill* is now.

A. Commerce Clause Principles

This Court has repeatedly held that the Commerce Clause prohibits the States from unduly burdening interstate commerce. "The few simple words of the Commerce Clause . . . reflected a central concern of the Framers that was an immediate reason for calling the Constitutional Convention: the conviction that in order to succeed, the new Union would have to avoid the tendencies toward economic Bal-

kanization that had plagued relations among the Colonies and later among the States under the Articles of Confederation." *Hughes* v. *Oklahoma*, 441 U.S. 322, 325 (1979).

One burden that States are strongly tempted to impose is taxation that "imped[es] free private trade in the national marketplace." *Reeves, Inc.* v. *Stake*, 447 U.S. 429, 437 (1980). In *Complete Auto Transit, Inc.* v. *Brady*, 430 U.S. 274 (1977), this Court articulated the standard for evaluating when such state taxes violate the Commerce Clause. Under that test, a state tax is permissible only if the "tax [1] is applied to an activity with a *substantial nexus with the taxing State*, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State." *Id.* at 279 (emphasis added).

This case concerns the application of *Complete Auto*'s "substantial nexus" requirement to state taxation of businesses that have no in-state physical presence. Before *Complete Auto*, this Court confronted such a tax in *National Bellas Hess, Inc.* v. *Department of Revenue of Illinois*, 386 U.S. 753 (1967), holding that a State could not impose a use tax on a mail-order company with no in-state physical presence. The Court explained that imposing sales and use taxes on out-of-state firms would place "unjustifiable local entanglements" on interstate commerce." *Id.* at 759-760.

In *Quill Corp.* v. *North Dakota*, 504 U.S. 298 (1992), this Court eliminated any doubt that *Bellas Hess* retained its vitality when analyzed using *Complete Auto*'s "substantial nexus" terminology. The North Dakota Supreme Court had held that the State could impose a use tax on a mail-order office

supply retailer with no in-state outlets or personnel because, in its view, *Bellas Hess*'s bright-line requirement had been rendered "obsole[te]" by *Complete Auto* and "the tremendous social, economic, commercial, and legal innovations" that had taken place since *Bellas Hess*. *State* v. *Quill Corp.*, 470 N.W.2d 203, 208 (N.D. 1991). This Court reversed, reaffirming the physical-presence requirement. The Court held that the Commerce Clause's "substantial nexus" prerequisite is not satisfied when the nondomiciliary taxpayer has no property or personnel within the State, even though it may transact business with state residents through the channels of interstate commerce. 504 U.S. at 314-318.

B. Factual Background

1. At all times relevant here, petitioner Capital One Bank (now Capital One Bank (USA), N.A.) was a bank chartered and domiciled in Virginia that offered credit cards to its customers. App. 1a-3a. Petitioner Capital One F.S.B. (now Capital One, N.A.) was a federally-chartered savings bank that offered secured and unsecured credit cards and unsecured installment and consumer home loans. App. 3a. Petitioners issued general-purpose credit cards to Massachusetts residents as part of national marketing efforts. App. 3a-4a. Petitioners did not own or lease any real property in Massachusetts, nor did they own any other in-state property. App. 3a. Moreover, petitioners had no employees, agents, or independent contractors in Massachusetts. *Id.*

As members of Visa and MasterCard, two associations of banks, petitioners were "issuing banks" that issued credit cards bearing the "Capital One" name and branded with a Visa or MasterCard logo as appropriate. App. 4a-5a. Other members of the

associations served as "acquiring banks" that entered into contractual arrangements with merchants that accepted Visa or MasterCard. App. 6a-7a. Credit card transactions were enabled by the transmission of customer and bank information over electronic computer and telephone networks that cross state lines—that is, by the transmission of information through channels of interstate commerce. *Id.*

When their customers paid for goods or services with their credit cards, petitioners effectively guaranteed payment to the merchants and thus bore the risk of non-payment by the customers. App. 7a. Petitioners' primary assets consisted of unsecured consumer loans arising from customer use of Capital One credit cards. App. 25a. Petitioners generated interest and other income through finance charges on outstanding loan receivables, fees from credit card transactions, and interest on investments. *Id.*

Petitioners worked with collection agencies and attorneys to collect delinquent customer accounts. App. 7a & n.10. Capital One Services, Inc., an affiliate of petitioners' parent, occasionally engaged attorneys in Massachusetts to bring actions against defaulting customers. App. 29a.

2. The Massachusetts financial institution excise tax (FIET) statute provides: "[E]very financial institution engaged in business in the commonwealth shall pay, on account of each taxable year, an excise measured by its net income determined to be taxable . . . ." MASS. GEN. LAWS ch. 63, § 2 (App. 66a-69a). FIET liability is based on a percentage of a financial institution's net income. *Id.*[1]

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[1] Respondent agreed with petitioners' characterization of the FIET as a "tax" on petitioners' income, even though in Massa-

The FIET applies to any financial institution that "regularly engag[es] in transactions with customers in the commonwealth that involve intangible property and result in income flowing to the taxpayer from residents of the commonwealth," even if the taxpayer has no physical presence in Massachusetts. MASS. GEN. LAWS ch. 63, § 1 (App. 56a). A financial institution is presumed to be taxable if it engages in transactions with 100 residents or has $10 million in assets or $500,000 in receipts attributable to Massachusetts. *Id.*

C. Procedural Background

1. Respondent, the Commissioner of Revenue of Massachusetts, sought to impose the FIET on Capital One Bank for the years 1995 through 1998, and on Capital One F.S.B. for the years 1996 through 1998. App. 1a-2a. After respondent assessed FIET liability of $1,758,454 against Capital One Bank and $159,075.25 against Capital One F.S.B., petitioners applied for abatement, arguing that the Commerce Clause prohibited the assessments. App. 8a-9a. Respondent denied petitioners' applications. App. 9a.

[Footnote continued from previous page]

chusetts there are "historical differences between a tax and an excise." App. 1a-2a n.2. In any event, where, as here, a state tax is measured by a share of a taxpayer's net income, the statutory designation of that tax is irrelevant for purposes of the "substantial nexus" inquiry—regardless of whether the tax is called an excise, franchise tax, business-license tax, gross-receipts tax, value-added tax, or capital-stock tax. *Cf. Hunt-Wesson, Inc.* v. *Franchise Tax Bd. of Cal.*, 528 U.S. 458, 464 (2000) (a "tax on sleeping measured by the number of pairs of shoes you have in your closet is a tax on shoes") (internal quotation marks omitted).

2. The Appellate Tax Board upheld respondent's denial of abatement. App. 23a-53a. The Board rejected petitioners' claim that Massachusetts could not, consistent with the Commerce Clause, impose the FIET on petitioners' income because they had no in-state physical presence and therefore lacked a "substantial nexus" with Massachusetts. App. 30a-32a.

3. The SJC affirmed. App. 1a-22a. Petitioners' core argument, the SJC stated, "is that the board erroneously limited to the sales and use tax context the United States Supreme Court's holding in *Quill* . . . that the Federal commerce clause precludes a State from imposing tax obligations on an out-of-State corporation that has no physical presence in the taxing State." App. 11a.

The SJC disagreed, holding instead that *Quill* had a "narrow focus on sales and use taxes for the physical presence requirement," a requirement that "did not apply to the imposition of other types of State taxes." App. 17a. The SJC relied heavily on dicta in *Quill*, in which this Court remarked that "it had not, 'in [its] review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes,'" and that "'concerning other types of taxes, [it had] not adopted a similar bright-line, physical-presence requirement.'" App. 16a-17a (quoting 504 U.S. at 314, 317 (alterations in original)). In addition, the SJC reasoned that for "substantial nexus" purposes, state income taxes on non-domiciliary corporations are constitutionally distinguishable from sales and use taxes because the former are *per se* less burdensome than the latter: "An income-based excise," the SJC opined, "typically is paid only once a year . . . to one taxing jurisdiction at the State level, and the

payment of such an excise does not entail collection obligations vis-à-vis consumers." *Id.* at 20a n.17.

Although it rejected physical presence as a prerequisite, the SJC identified no method for determining what degree of connection short of physical presence counts as a "substantial nexus." Instead, the SJC expressed agreement with another court's conclusion that a mere "significant economic presence" within the state was sufficient to justify income taxation. App. 20a.

The SJC then announced that the "substantial nexus" requirement was satisfied in this case, because petitioners "were providing valuable financial services to Massachusetts consumers" by "using Massachusetts banking and credit facilities"; petitioners "addressed customer complaints with the assistance of the Massachusetts Attorney General's office"; and petitioners "used the Massachusetts court system to recover payment for delinquent accounts." App. 22a. The SJC thus upheld taxation of petitioners' income under the Commerce Clause (*id.*), based in part on the view that the entire "'notion of physical presence'" was "'anachronistic'"—"even more" so "today than it was in 1992," when *Quill* was decided (*id.* at 21a n.18 (quoting 504 U.S. at 327-328 (White, J., dissenting in part)).

REASONS FOR GRANTING THE PETITION

I. THE DECISION BELOW CONFLICTS WITH THIS COURT'S PRECEDENTS

The Supreme Judicial Court's resolution of the important constitutional question presented is irreconcilable with the reasoning employed by this Court in *Quill* and other cases. In particular, the SJC (1) artificially constricted the physical-presence rule

to the sales-and-use-tax context, overlooking *Quill*'s significance as an authoritative construction of *Complete Auto*'s universal "substantial nexus" requirement; (2) improperly ignored the heavy burdens on interstate commerce imposed by state income taxes, in an attempt to justify preferential treatment of such taxes; (3) impermissibly elevated form over substance in treating sales and use taxes as entirely distinct from income taxes for purposes of assessing "substantial nexus"; (4) failed to consider the practical benefits for interstate commerce of adherence to a clear physical-presence standard rather than the SJC's vague economic-nexus approach; and (5) conflated the "substantial nexus" inquiry under the Commerce Clause with the "minimum contacts" inquiry under the Due Process Clause. This Court's review is necessary to address the SJC's profound misinterpretation of the "substantial nexus" prong, and to clarify that *Quill*'s physical-presence requirement extends beyond the narrow corner into which the SJC confined it.

A. *Quill*'s Explication Of "Substantial Nexus" Cannot Be Confined To The Sales-And-Use-Tax Context

Quill held that the physical-presence requirement for state taxation of non-domiciliaries, as articulated in *Bellas Hess*, correctly implements the constitutional mandate that the taxpayer must have a "substantial nexus" with the taxing State. *Quill* did not explicitly resolve the question whether the physical-presence requirement extends to taxes other than sales and use taxes, instead leaving that question for later consideration (504 U.S. at 314, 317), but the Court's reasoning points inexorably to an affirmative answer to that question. *Quill* reaffirmed

that "a vendor whose only contacts with the taxing State are by mail or common carrier lacks the 'substantial nexus' required by the Commerce Clause." *Id.* at 311. Indeed, this Court has *never* construed the Constitution to authorize a State to impose *any* tax on an out-of-state entity that neither owns any property within the State nor maintains any representatives (whether employees or independent contractors) within the State.

The logic of *Quill* is clear: The Commerce Clause requires a "substantial nexus" for *all* state taxation, and a "substantial nexus" requires that a nondomiciliary corporation have a physical presence in the State before it may be taxed. Mere contact with residents of the State through the channels of interstate commerce, such as "by mail or common carrier," will not suffice. *Id.* Connections between a taxpayer and a State that are equivalent to those present in *Bellas Hess* or *Quill* do not constitute "substantial nexus," a principle that logically applies with equal force to all state taxation of interstate transactions, whether denominated sales, use, income, or excise taxes. Accordingly, while *Quill* applied Commerce-Clause principles to a use tax, lower courts are not free to confine the physical-presence requirement to that context alone.

Defying those principles, the SJC held that *Bellas Hess* and *Quill* are limited to their facts and that the physical-presence requirement has a "narrow focus on sales and use taxes." App. 17a. No precedent, however, justifies subjecting sales and use taxes to *sui generis* constitutional analysis. Instead, this Court has regularly cited *Bellas Hess* when examining taxes outside the sales-and-use class under *Complete Auto*, indicating that the physical-presence rule applies more broadly. *See Tyler Pipe Indus., Inc.* v.

Wash. State Dep't of Revenue, 483 U.S. 232 (1987) (business and occupation taxes); *Commonwealth Edison Co.* v. *Montana*, 453 U.S. 609 (1981) (severance taxes); *Goldberg* v. *Sweet*, 488 U.S. 252 (1989) (excise taxes). That is, *Bellas Hess* and *Quill* addressed use taxes, but announced a rule applicable to state taxation generally. *See Commonwealth Edison*, 453 U.S. at 626 (citing *Bellas Hess* in severance-tax case to support statement that "the interstate business must have a substantial nexus with the State before *any* tax may be levied on it") (emphasis in original). In that respect, *Bellas Hess* and *Quill* resemble *Complete Auto*, which addressed sales taxes but also established a rule applicable to income taxes. *See, e.g.*, *Barclays Bank PLC* v. *Franchise Tax Bd. of Cal.*, 512 U.S. 298, 310-311 (1994).

This Court itself, even before *Bellas Hess*, applied the physical-presence requirement to taxes analogous to the income tax at issue here. In *Norton Company* v. *Department of Revenue of Illinois*, 340 U.S. 534 (1951), Illinois imposed a gross-receipts tax (a tax on a firm's total revenues) on an out-of-state corporation. This Court explained that "[w]here a corporation chooses to stay at home in all respects except to send abroad advertising or drummers to solicit orders which are sent directly to the home office for acceptance, filling, and delivery back to the buyer, it is obvious that the State of the buyer *has no local grip on the seller*." *Id.* at 537 (emphasis added). Because the corporation had a Chicago branch, however, the Court held that Illinois could tax earnings produced through that branch, but not earnings produced through direct-mail orders to the firm's out-of-state headquarters. *Id.* at 537-539. As in *Bellas Hess* and its progeny, the dispositive question for Commerce-Clause purposes in *Norton* was whether

the taxpayer had a physical presence in the taxing state.[2]

The SJC thus had no principled basis for cabining *Quill* to the sales-and-use context. The logic of *Quill* applies to income taxation as well. This Court's review is required to ensure that state courts give full effect to the necessary implications of the "substantial nexus" principles enunciated in *Quill*.

B. The SJC Contradicted This Court's Assessment Of The Economic Burdens Imposed By Income Taxes

The SJC also disregarded this Court's mandate that proper analysis of a Commerce-Clause challenge to a state tax requires consideration of the true burdens imposed by the tax on firms engaged in interstate commerce. As this Court explained, the purpose of the "substantial nexus" requirement is to "limit the reach of state taxing authority so as to ensure that state taxation does not unduly burden interstate commerce." *Quill*, 504 U.S. at 313.

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2 *Accord Standard Pressed Steel Co.* v. *Wash. Revenue Dep't*, 419 U.S. 560, 562 (1975) (holding that imposition of gross-receipts tax on out-of-state corporation was justified, not by substantial sales in State, but because the corporation had an "employee . . . with a full-time job within the State"); *see also Nat'l Geographic Soc'y* v. *Cal. Bd. of Equalization*, 430 U.S. 551, 557 (1977) ("*Standard Pressed Steel* held that maintenance in the taxing State of a single employee . . . whose primary responsibility was to consult with the Washington-based customer regarding its anticipated needs for the out-of-state supplier's product[] established a sufficient relation to activities within the State producing the gross receipts as to support imposition of the tax.").

The *Quill* Court recognized that when sales and use taxes are concerned, the obligations imposed on out-of-state firms would be "unduly burden[some]" in the absence of a physical-presence rule. *Id.* at 313-316 & n.6. The SJC gave short shrift to those concerns in this case, blithely opining that income taxes impose less substantial burdens on out-of-state corporations than do sales and use taxes. App. 19a-21a & n.17. That conclusion conflicts directly with this Court's precedents, which make clear that state income taxes place a significantly *greater* burden on firms engaged in interstate commerce than do the sales and use taxes at issue in *Quill* and *Bellas Hess*.

In particular, this Court has recognized that the burden on out-of-state firms is greater from income-based taxes than from sales and use taxes because the latter require only that firms *collect* the levies from purchasers, whereas income taxes require businesses to *pay* the tax out of their own earnings and also to comply with far more complicated and detailed administrative and computational rules. *See Nat'l Geographic*, 430 U.S. at 557-558 (concluding that "[t]he case for the validity of" a "use tax" is "stronger" than that for a tax on an out-of-state corporation's revenues, because "[t]he out-of-state seller" bears only "the administrative [burden] of collecting" the use tax); *Norton*, 340 U.S. at 537 (concluding that "a state imposing a sales or use tax can more easily meet this burden" of establishing the requisite nexus "because the impact of those taxes is on the local buyer or user," unlike a gross-receipts tax).

The financial obligation imposed by income taxes is thus far more onerous than that imposed by sales taxes, not only because income taxes fall directly on and must be paid by the out-of-state business out of

its own earnings, but also because income taxation by multiple jurisdictions can lead to double taxation. *See Nat'l Geographic*, 430 U.S. at 557-558 (describing the "risk of double taxation" as one reason why income taxes are more constitutionally problematic than sales taxes).[3] The economic-nexus approach adopted by the court below would greatly exacerbate the risk of double taxation by making it far more likely for businesses—even relatively small businesses doing interstate business—to be subjected to taxation in multiple States.

The *administrative* burdens of complying with numerous and disparate income taxation regimes are also onerous. Each jurisdiction can have its own apportionment formulae, sourcing definitions, income classification, depreciation, disclosure requirements, deductions and various other statutory requirements—and these requirements can vary widely among jurisdictions. For example, the tax at issue in this case requires compliance with pages of statutory apportionment rules alone. *See* Mass. Gen. Laws, ch. 63, § 2 (App. 66a-69a); *see generally* Marjorie Gell, *Broken Silence: Congressional Inaction, Judicial Reaction, and the Need For a Federally Man-*

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[3] Because of differences in state apportionment rules, a taxpayer physically located in one State that becomes subject to another State's taxing power on an "economic nexus" theory may be taxed on income that is already being taxed by its domiciliary State. Indeed, Capital One, N.A., faced that situation here, because the income that Massachusetts seeks to tax was already taxed by Virginia. Although this Court has kept substantial-nexus analysis distinct from fair-apportionment analysis, the enhanced risk of double taxation posed by the "economic nexus" theory confirms the need for a physical-presence requirement in order to avoid unduly burdening interstate commerce.

dated Physical Presence Standard For State Business Activity Taxes, 6 PITT. TAX REV. __, __ (manuscript at 22) (forthcoming Spring 2009) (requiring physical presence is even more appropriate for business-activity taxes than for sales and use taxes "because of the sheer number and complexity of different types of business activity taxes as compared to sales and use taxes"). In addition to States, various municipalities—including localities of very different sizes, ranging from New York City (N.Y.C. ADMIN. CODE § 11-603 (2008)) to Hamilton, Ohio (Ordinance 191.03(b) (2001))—have their own corporate income taxes.

Consequently, the burden of complying with the various requirements of the numerous income-taxing jurisdictions, each with its own unique and often contradictory requirements, can become a crushing one for multi-state corporations or small businesses selling products or services nationwide (for example, through the Internet). *See* Megan A. Stombock, *Economic Nexus and Nonresident Corporate Taxpayers: How Far Will It Go?*, 61 TAX LAW. 1225, 1241 (2008). Indeed, abandoning the physical-presence requirement "would require taxpayers to analyze their activities on a jurisdiction-by-jurisdiction, entity-by-entity, year-by-year, and issue-by-issue basis through extensive record maintenance, timely filings in support of returns, potential simultaneous audits, and negotiations and litigations in multiple jurisdictions." *Id.* Adhering to *Quill* would eliminate the burdens and uncertainty fostered by the SJC's approach.

C. The Decision Below Conflicts With This Court's Rejection Of Formalism In Commerce-Clause Analysis

The upshot of the SJC's artificial constriction of *Quill* is that States, by designating a tax as an income tax rather than a sales and use tax, will be able to evade the Constitution's physical-presence requirement for taxation of out-of-state businesses. Under the SJC's view, the very same activities that are constitutionally insufficient to establish "substantial nexus" for purposes of the sales tax *do* suffice to create such a nexus when the State chooses to impose an income tax instead.

If the SJC's understanding of *Quill* were correct, North Dakota could have responded to invalidation of its use tax on non-domiciliary catalog retailers by simply imposing an excise or other tax on the revenues those same retailers earned on sales to North Dakotans. By simple labeling, the State could freely manipulate application of the physical-presence requirement affirmed in *Quill*.

This Court has refused to give States such an "on-off" switch. "*Complete Auto* emphasized the importance of looking past 'the formal language of the tax statute [to] its practical effect,'" because "differently denominated tax[es] with the same economic effect" must be treated similarly. *Quill*, 504 U.S. at 310 (quoting 430 U.S. at 279) (alteration in original). The decision below thus conflicts with *Quill* and *Complete Auto* by resurrecting a thoughtless formalism that applies one method of constitutional analysis to sales and use taxes, while refusing to apply that same methodology to other taxes, even those (like income taxes) that impose greater burdens on

interstate commerce. This Court's precedents reject that misguided approach.

D. The SJC Disregarded *Quill* By Ignoring The Constitutionally-Significant Benefits Of A Bright-Line Rule

Equally inconsistent with *Quill* is the SJC's disregard for the benefits of a clear and consistent bright-line physical-presence rule. This Court emphasized that a bright-line rule "firmly establishes the boundaries of legitimate state authority to impose" tax obligations, "reduces litigation concerning those taxes," "encourages settled expectations," and "fosters investment by businesses and individuals." *Quill*, 504 U.S. at 315-316. Accordingly, the Court concluded that "the bright-line [physical-presence] rule of *Bellas Hess* furthers the ends of the dormant Commerce Clause" through "the demarcation of a discrete realm of commercial activity that is free from interstate taxation." *Id.* at 314-315.

The Court acknowledged that this rule, "[l]ike other bright-line tests," may "appear[] artificial at its edges," but any "artificiality" is "more than offset by the benefits of a clear rule." *Id.* at 315. Clarity is particularly important in this context because "[the] law in this area is something of a 'quagmire' and the 'application of constitutional principles to specific state statutes leaves much room for controversy and confusion and little in the way of precise guides to the States in the exercise of their indispensable power of taxation.'" *Id.* at 315-316 (quoting *Nw. States Portland Cement Co.* v. *Minnesota*, 358 U.S. 450, 457-458 (1959)).

Those benefits of the bright-line physical-presence requirement apply *a fortiori* to income

taxes. But the vague economic-nexus approach adopted by the court below flies directly in the face of the *Quill* Court's emphasis on clarity and ease of application. Asserting that the "concept of 'substantial nexus' is more elastic than 'physical presence'" (App. 22a), the SJC announced that petitioners had a substantial nexus with Massachusetts without setting forth *any* standard that would enable out-of-state firms to determine what general conduct suffices to enable the State to tax income. The SJC suggested, for example, that "us[e]" of "Massachusetts banking and credit facilities" in the course of "provid[ing] . . . services" to Massachusetts customers alone might be justification enough (*id.*), which invites a host of questions—and raises the prospect that, for example, the SJC would uphold under the Commerce Clause a tax imposed on a non-domiciliary firm that merely cashed checks drawn on a Massachusetts bank. Thus, the decision below clarifies nothing. Instead it sows confusion about the taxing power and increases the compliance burdens imposed on interstate businesses. *Quill*'s bright-line rule avoids exactly that outcome, and the SJC erred in departing from it.

E. The SJC Contradicted *Quill* By Conflating The Separate Analyses Under The Due Process And Commerce Clauses

The SJC's "elastic" standard conflicts with *Quill* in yet another respect. In concluding that petitioners had a "substantial nexus" sufficient to justify Massachusetts' income taxation, the SJC essentially dismantled the fence erected by this Court to separate the Due Process and Commerce Clause inquiries.

The Court in *Bellas Hess* held that a use tax on firms with no in-state physical presence violated both the Due Process and Commerce Clauses, with-

out drawing a clear distinction between the inquiries under those distinct provisions. 386 U.S. at 756-760. *Quill* reaffirmed *Bellas Hess*'s Commerce Clause holding, but not its Due Process holding. In so doing, this Court explained that "the 'substantial nexus' requirement is not, like due process' 'minimum contacts' requirement, a proxy for notice, but rather a means for limiting state burdens on interstate commerce." 504 U.S. at 313. In other words, the question under the Commerce Clause is not whether it is "fair" to subject a company to taxation in a particular State, but whether a state tax will place an undue burden on interstate commerce. *Id.*

Although the SJC purported to acknowledge the difference between the Due Process and Commerce Clause analyses, its truncated nexus discussion amounted merely to the "fairness" inquiry, looking exclusively to the benefits that petitioners received from engaging in business transactions with Massachusetts customers and using state-based services. App. 22a. The SJC's reliance, for example, on petitioners' "soliciting and conducting significant credit card business" with Massachusetts residents (*id.*) essentially mimicked the analysis that would have been appropriate under the Due Process Clause to determine whether petitioners could be sued in Massachusetts courts. *See, e.g.*, *Burger King Corp.* v. *Rudzewicz*, 471 U.S. 462, 472 (1985). The SJC thereby collapsed the Due Process and Commerce Clause inquiries in exactly the way *Quill* forbids.

II. THE DECISION BELOW EXACERBATES A GROWING CONFLICT AMONG STATE APPELLATE COURTS OVER APPLICATION OF *QUILL* TO INCOME TAXATION

The decision below expands the preexisting conflict among state appellate courts over the question whether *Quill*'s interpretation of the substantial-nexus prong can be confined to sales and use taxes. That conflict is now both clear and mature. Indeed, it has become more pronounced since this Court last considered the question, and only review by this Court will resolve the conflict.

In holding that *Quill*'s interpretation of "substantial nexus" was dependent on and strictly limited to the particular tax at issue in that case, the court below followed the West Virginia Supreme Court of Appeals, which reached the same conclusion in *Tax Commissioner* v. *MBNA America Bank, N.A.*, 640 S.E.2d 226 (W. Va. 2006) ("*MBNA*"), *cert. denied sub nom. FIA Card Servs., N.A.* v. *Tax Comm'r of W. Va.*, 127 S. Ct. 2997 (2007). Volunteering that the physical-presence test reaffirmed by this Court in *Quill* "makes little sense in today's world," the West Virginia court announced that *Quill* "applies only to sales and use taxes" and not to other state taxes. *Id.* at 234. In lieu of the *Quill* test, the court selected an amorphous "economic presence" standard for assessing "substantial nexus." *Id.* The dissent vigorously criticized the majority's "strained and inaccurate reading" of *Quill* and its reliance on "legal commentaries with thinly veiled state-favoring taxing agendas," observing that "[i]t would be a strange constitutional doctrine that would countenance one nexus standard for sales and use taxes under the Commerce Clause, and a more relaxed nexus standard for

corporate net income and other state taxes." *Id.* at 236, 239-240 (Benjamin, J., dissenting).

The Indiana Tax Court also recently and explicitly sided with West Virginia. *See MBNA Am. Bank, N.A.* v. *Ind. Dep't of State Revenue*, 895 N.E.2d 140 (2008). Relying on the West Virginia *MBNA* decision, the Indiana court upheld the challenged tax because it viewed "economic presence" as establishing substantial nexus. *Id.* at 144.[4]

Other state appellate courts have reached the opposite conclusion, recognizing that the *Quill* Court's rationale cannot arbitrarily be limited to the particular tax at issue there because the Court was construing the meaning of the "substantial nexus" requirement, which applies to *all* state taxes. Most saliently, in *J.C. Penney National Bank* v. *Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), the Tennessee Court of Appeals rejected the State's bid to cabin *Quill* to sales and use taxes, seeing "no basis for concluding that the analysis should be different in the present case." *Id.* at 839. As the court observed, none of this Court's precedents has "upheld a state tax where the out-of-state taxpayer had absolutely no physical presence in the taxing state." *Id.* at 842. The court concluded that the taxpayer—like petitioners here, a non-domiciliary credit card issuer with no in-state personnel or property—lacked the substantial nexus required to sustain the franchise and excise taxes imposed. *Id.* The Tennessee Supreme Court denied review, and permitted publication of the Court of Appeals' decision. *J.C. Penney*, No. M1998-00497-SC-R11-CV (Tenn. May 8, 2000)

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[4] Indiana Tax Court decisions are directly appealable to the Indiana Supreme Court. *See* IND. APP. P. R. 63(A).

(per curiam). That order gave the appellate court's decision binding statewide precedential effect. *See Meadows* v. *State*, 849 S.W.2d 748, 752 (Tenn. 1993) (published opinions of Tennessee Court of Appeals may be relied on with same "confidence and reliability" as those of Tennessee Supreme Court).[5]

The direct conflict between the decision below and *J.C. Penney*—the functional equivalent of a judgment by the highest court of Tennessee—makes this Court's intervention necessary.[6] In addition, however, appellate courts in other States have also rejected the view, adopted below, that *Quill*'s reasoning is limited to the sales-and-use-tax context.

Thus, in *Rylander* v. *Bandag Licensing Corp.*, 18 S.W.3d 296 (Tex. App. 2000), a case involving a state franchise tax, the Texas Court of Appeals explicitly considered and rejected the State's assertion that

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[5] The West Virginia (640 S.E.2d at 235) and Indiana (895 N.E.2d at 143) courts acknowledged, but failed to grapple with, *J.C. Penney*. The SJC erroneously deemed *J.C. Penney* to have been undercut by a later unpublished decision. App. 18a n.16 (citing *Am. Online, Inc.* v. *Johnson*, No. M2001-00927COA-R3-CV, 2002 WL 1751434 at *2 (Tenn. Ct. App. July 30, 2002) ("*AOL*")). But *AOL* held merely that disputed fact issues foreclosed summary judgment, because it was unclear to what extent the taxpayer had personnel or leased components in the State. 2002 WL 1751434 at *1, *3. Moreover, the unpublished *AOL* decision could not have overruled the published *J.C. Penney* decision. *See Allstate Ins. Co.* v. *Watts*, 811 S.W.2d 883, 886 n.2 (Tenn. 1991) (unpublished decisions have only "persuasive force").

[6] This Court has often addressed Commerce-Clause issues in the state taxation context without waiting for the emergence of a split in authority as pronounced and mature as the one here. *See* Cert. Pet. in *Hunt Wesson, Inc.* v. *Franchise Tax Bd. of Cal.*, No. 98-2043, at 15-27 (no conflict asserted); Cert. Pet. in *General Motors Corp.* v. *Tracy*, No. 95-1232, at 14 (same).

"*Quill Corp.* and *Bellas Hess* should be limited to the context of sales and use taxes." *Id.* at 299. The court explained that, "[w]hile the decisions in *Quill Corp.* and *Bellas Hess* involved sales and use taxes, we see no principled distinction when the basic issue remains whether the state can tax the corporation at all under the Commerce Clause." *Id.* at 300. "[W]hen the corporation conducts its activity solely through interstate commerce and lacks any physical presence in the state," the court concluded, "no sufficient nexus exists to permit the state to assess tax." *Id.*

Similarly, in *Guardian Industries Corp.* v. *Department of Treasury*, 499 N.W.2d 349 (Mich. Ct. App. 1993), an in-state taxpayer contended that "because it was subject to income taxation for sales in" other, "target" States in which it had solicited business, it was entitled under Michigan law to reduce the amount of its income taxable in Michigan by a corresponding amount. *Id.* at 352-353. The then-applicable statute exempted sales taxable in another State from Michigan tax if "that [other] state has jurisdiction" to impose the tax. *Id.* at 353 (quoting MICH. STAT. ANN. § 7.558(42)). The dispositive question, therefore, was whether income taxation by "target" States would violate the Commerce Clause. *Id.* at 356. The court held that the physical-presence test controlled the answer: "[A]fter *Quill*, it is abundantly clear that Guardian must show a physical presence within a target state to establish a substantial nexus to it." *Id.* Remanding for factual development, the court explained that "[a] target state that taxed Guardian's [sales] solicitation activities would be in violation of the [C]ommerce [C]lause if Guardian's employees were never present within the state." *Id.* at 357.

The decision below therefore is irreconcilable with the reasoning of appellate decisions in Tennessee, Texas, and Michigan, each of which holds that *Quill's* interpretation of "substantial nexus" cannot be confined to the sales-and-use-tax context. This conflict among state appellate courts is now substantial and mature. Resolution by this Court is necessary.[7]

Because the constitutional question presented arises from state taxation, this Court cannot await a federal circuit conflict before answering it. Taxpayers are barred from raising Commerce-Clause challenges to state taxes in the lower federal courts, because the Tax Injunction Act prohibits those courts from restraining "the assessment, levy or collection of any tax under State law where a plain, speedy and

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[7] A distinct question is whether a State may tax nondomiciliaries (often called intangible holding companies) whose only assets are intellectual property rights that they license to corporations—typically commonly-owned—that use those rights within the State while selling goods or services, and pay royalties to the out-of-state licensor. Some courts addressing intangible holding companies have held that the out-of-state licensor's lack of physical presence does not bar taxation. *See Bridges* v. *Geoffrey, Inc.*, 984 So.2d 115 (La. Ct. App. 2008); *Lanco, Inc.* v. *Dir., Div. of Taxation*, 908 A.2d 176 (N.J. 2006); *A&F Trademark, Inc.* v. *Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004); *Kmart Props., Inc.* v. *Taxation & Revenue Dep't of N.M.*, 131 P.3d 27 (N.M. Ct. App. 2001); *Geoffrey, Inc.* v. *Okla. Tax Comm'n*, 132 P.3d 632 (Okla. Civ. App. 2005); *Geoffrey, Inc.* v. *S.C. State Tax Comm'n*, 437 S.E.2d 13 (S.C. 1993). Those cases are not controlling here, as the SJC acknowledged; they "involved foreign corporations with intangible property . . . that was being used in the taxing State by a licensee." App. 21a n.19. By contrast, during the tax years at issue here, petitioners did not earn income through the in-state use of their intellectual or other property by a commonly-controlled affiliate.

efficient remedy may be had in the courts of such State." 28 U.S.C. § 1341. Accordingly, this Court is the *only* federal court that can resolve the growing disagreement and confusion in the state appellate courts regarding the import of this Court's decision in *Quill*.

III. THE QUESTION PRESENTED IS CRITICALLY IMPORTANT TO INTERSTATE COMMERCE AND WARRANTS THIS COURT'S REVIEW AT THIS TIME

As *Bellas Hess* and *Quill* recognized, when a state abandons the physical-presence requirement, it adversely affects interstate commerce by creating confusion and placing onerous burdens on multistate firms. In recent years, those harms have multiplied, as a growing number of States has adopted amorphous and inconsistent economic-nexus tests for income and excise taxes. That trend accelerated after this Court's denial of certiorari in *MBNA*, and is growing increasingly out of control as ever-more States seek to increase their revenues at the expense of out-of-state businesses. Given the current economic crisis and Congress's consistent inaction, only a ruling from this Court can stop the flood of state efforts to impose unduly heavy burdens on interstate commerce.

A. State Abandonment Of The Physical-Presence Requirement Harms The Nation's Economy

The question presented is "one of the most important unanswered questions facing state taxpay-

ers,"[8] because it has major implications for every taxpayer whose business activities cross state lines. At present, the lack of sufficiently clear guidance from this Court regarding the constitutional limits on state income taxation of out-of-state corporations has led to a confusing patchwork of inconsistent state case law, legislation, and administrative determinations adopting widely varying standards for identifying those limits.[9] State approaches range from continued insistence on the physical-presence requirement to various versions of the economic-nexus approach, often with different standards applied to different types of entities.[10]

This wide variation among the States regarding what is fundamentally a question of federal constitutional law creates substantial burdens and uncertainty for businesses faced with deciding whether they are obligated to pay income taxes in multiple States. *See* Stombock, *supra*, at 1231. Particularly

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[8] Marianne Evans & Sarah McGahan, *Economic Nexus and the Uncertainty of* Quill's *Physical-Presence Test*, THE TAX ADVISER (June 2007).

[9] *See* Point II, *supra*; Arthur R. Rosen & Jeffrey S. Reed, *Stop the State Tax Grab*, LEGAL TIMES, April 14, 2008 at 28 (observing that "what constitutes 'substantial nexus' is unclear and has provoked a firestorm of fierce debate"); Gell, *supra*, (manuscript at 22); Joseph Henchman, *Why The* Quill *Physical Presence Rule Shouldn't Go The Way Of Personal Jurisdiction*, 46 STATE TAX NOTES 387 (Nov. 5, 2007); Julie Roman Lackner, Note, *The Evolution and Future of Substantial Nexus in State Taxation of Corporate Income*, 48 B.C. L. REV. 1387, 1408-1415 (2007).

[10] For example, some States have pursued non-domiciliary financial institutions with particular force. *See* Jerome R. Hellerstein & Walter Hellerstein, STATE TAXATION ¶ 6.30 (3d ed. 1998 & Supp. 2009).

problematic in this regard are those States, now including Massachusetts, that have rejected the traditional bright-line physical-presence standard in favor of some version of "economic nexus." That inherently vague approach maximizes discretion in the tax collector, provides little or no guidance to potentially liable multistate businesses, and greatly increases the risk of double taxation. *See* Point I.B., *supra.*

Even when two States both say they apply an "economic nexus" standard, that phrase is so malleable that they may mean very different things. States are thus sowing confusion even as they seriously undermine the Commerce Clause's restraint on state taxation. *See* n.9, *supra*; n.12, *infra*; *see also* Stombock, *supra*, at 1231. This growing uncertainty is exactly the sort of "controversy and confusion" that has previously been of concern to this Court, offering "little in the way of precise guides to the States in the exercise of their" taxation powers. *Quill*, 504 U.S. at 315 (internal quotation marks omitted).

The cost of complying with state income taxes is already double the cost of complying with the federal income tax, and such disproportionate compliance costs will only increase as firms are required to file in more and more jurisdictions under vague "economic nexus" tests. *See* Sanjay Gupta & Lillian Mills, *Does Disconformity in State Corporate Income Tax Systems Affect Compliance Cost Burdens?*, 56 NAT'L TAX J. 355, 357 (2003). This increased burden will hit small and medium-sized businesses especially hard, because those firms do not have the resources to comply with numerous different income taxation regimes or contest tax assessments in far-flung jurisdictions. Such businesses may well decide against expanding their operations to other States or the Internet, out of a justified fear that they may be

opening themselves up to onerous tax liabilities and compliance costs.[11]

Moreover, state abandonment of the physical-presence requirement threatens to disrupt this Nation's international tax policy. Pursuant to bilateral tax treaties, the United States has agreed not to impose national income taxes on foreign firms that do not have a "permanent establishment" in the United States, in exchange for reciprocal commitments from our treaty partners. *See* United States Model Income Tax Convention of November 15, 2006, art. 7, ¶ 1; *see also id.* art. 5. As States become more aggressive in enforcing income taxes against foreign-based corporations with no in-state physical-presence, that increasingly burdensome taxation will create tensions with our tax-treaty partners, potentially encouraging them to abandon their physical-presence commitments, thereby undermining the United States' efforts to promote foreign commerce and harming U.S.-based firms. As this Court has warned, "a state tax on the instrumentalities of foreign commerce may impair federal uniformity in an area where federal uniformity is essential." *Japan*

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11 Moreover, state abandonment of the physical-presence requirement hampers business compliance with applicable accounting rules. Under Interpretation Number 48 issued by the Financial Accounting Standards Board—which sets standards for preparing audited financial statements in the United States—a corporation must record a liability for the full amount of an unpaid tax liability unless it is "more likely than not" that the corporation will prevail in contesting that liability. Uncertainty over the permissibility and meaning of the vague economic-nexus standard makes compliance with this requirement increasingly difficult and problematic. *See* Michael S. Schadewald, *FIN 48 Forces Companies to Wrestle with Uncertain State Nexus Standards*, THE CPA JOURNAL ONLINE (May 2008).

Line, Ltd. v. *County of Los Angeles*, 441 U.S. 434, 448-449 (1979). The prospect of interference with tax treaties is an especially dangerous one given the pressures toward protectionism and economic balkanization during the current economic crisis. *See* Emma Vandore, *OECD Warns Against Protectionism*, ASSOCIATED PRESS, March 3, 2009.

B. The Problem Has Grown Dramatically Worse Since The Denial Of Certiorari In *MBNA*

The need for this Court's review is more urgent now than it was when this Court denied certiorari in *MBNA* in 2007. Academic commentators and practitioners alike have increasingly recognized the problems created by state adoption of the economic-nexus approach and the growing uncertainty and confusion in this area of the law.[12] In addition, the past two years have seen a headlong rush by revenue-greedy state legislatures and tax collectors to adopt amorphous economic-nexus standards as a means of increasing tax revenues without raising the ire of in-state taxpayers.

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[12] *See, e.g.*, Giles Sutton et al., *Attributional Nexus, Flash Title, and the Chaos in Nexus Standards*, 50 STATE TAX NOTES 491 (Nov. 24, 2008); Edward A. Zelinsky, *Rethinking Tax Nexus and Apportionment: Voice, Exit, and the Dormant Commerce Clause*, 28 VA. TAX REV. 1, 15-20 (2008); articles cited *supra* n.9; *see also* David E. Wildasin, *State Corporation Income Taxation: An Economic Perspective on Nexus*, IFIR Working Paper No. 2009-08, at 13 (Feb. 2009) (economic analysis concluding that corporate income taxes imposed on out-of-state corporations based on in-state sales "impose[] an implicit tariff o[n] imports from other states, distorting interstate trade and generating deadweight efficiency losses").

As one major accounting firm recently observed: "The 'rash' of economic nexus decisions and legislation . . . really kicked off with the 2007 cert[iorari] denial[]" in *MBNA* and "spread like poison ivy in 2008." KPMG LLP, *2008: Year in Review*: *The "Economics" of 2008, in* TWIST-Q: A Quarterly Roundup of This Week in State Tax (Dec. 2008); *see also* Gell, *supra*, (manuscript at 24). Thus, numerous States have adopted economic-nexus approaches in the past two years. *See, e.g.*, Karen J. Boucher & Shona Ponda, *Current Corporate Income Tax Developments (Part I)*, THE TAX ADVISER 166, 166-168 (March 2009). The proliferation of economic-nexus theories since review was denied in *MBNA* has occurred notwithstanding this Court's reminders that denial of certiorari "imports no expression of opinion upon the merits of a case." *House* v. *Mayo*, 324 U.S. 42, 48 (1945). These state actions in disregard of *Quill* indicate that unless this Court intervenes, the burdens inflicted on interstate commerce by amorphous economic nexus standards will only continue to grow.

Just weeks after this Court denied review in *MBNA*, for example, the New Hampshire legislature amended the statutory definition of taxable "business activity" to include "a substantial economic presence evidenced by a *purposeful direction* of business toward the state examined in light of the frequency, quantity, and *systematic* nature of a business organization's economic *contacts* with the state" (emphases added). That amendment took effect July 1, 2007. Ch. 263 (H.B. 2), Laws 2007, amending N.H. REV. STAT. ANN. § 77-A:1, XII; *see* Chris Sullivan, *New Hampshire Adopts Economic Nexus Standard*, 45 STATE TAX NOTES 213 (July 23, 2007) (noting that the legislature "deferred consideration of the

provision while the economic nexus question was pending before the Supreme Court" and then acted promptly upon denial of certiorari).

Similarly, Michigan has embraced "a broadly expanded economic presence nexus standard that will increase the number of businesses subject to . . . tax" in the wake of the denial of review in *MBNA*. June Summers Haas, *The Michigan Business Tax Taxpayer: Jurisdiction to Tax and the Unitary Business Group*, 53 WAYNE L. REV. 1351, 1351 (2007). In particular, under the Michigan Business Tax (MBT), enacted in July 2007 (just weeks after the denial of certiorari) and effective January 1, 2008, a person is considered to have a nexus with Michigan sufficient to require payment of the MBT if the person "actively solicits" sales within the State, and has in-state gross receipts of or exceeding a specified dollar threshold. MICH. COMP. LAWS § 208.1200(1). Michigan has opined that "[w]hether substantial economic presence is established depends on the quality and quantity of the taxpayer's contacts with the taxing state and the degree to which the taxpayer exploits the market." Mich. Revenue Admin. Bulletin 2007-6, at 4 (Dec. 28, 2007). That highly malleable formulation "is more of a Due Process nexus standard" than a test under the Commerce Clause. Haas, *supra*, at 1359.[13]

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[13] California made a similar change recently in enacting its 2009-10 budget. Effective January 1, 2011, the State amended the statutory definition of "doing business" for tax purposes to cover any taxpayers whose in-state sales exceed the lesser of $500,000 or 25% of total sales. Senate Bill No. X3 15, § 7 (amending CAL. REV. & TAX. CODE § 23101(b)(2)) (enrolled Feb. 19, 2009); *see* Deloitte Development LLC, *California Budget Legislation Contains Significant Tax Law Changes* 4 (Feb. 27, 2009) ("The adoption of a doing business standard that relies

Other States likewise have seized upon denial of review in *MBNA* as an occasion for issuing regulatory guidance asserting authority to tax non-domiciliary corporations with no in-state physical presence. Florida, for example, found *MBNA* "persuasive, especially given the fact that the U.S. Supreme Court declined to hear the case[]." Fla. Dep't of Revenue, Advisement 07C1-007, 2007 WL 4577924, at *6 (Oct. 17, 2007); *see also* Me. Revenue Servs., Maine Tax Alert (Feb. 2008), 2008 WL 2764732, at **2-3 (noting denial of review in *MBNA*, and stating that Maine "considers taxpayers with economic nexus alone to be subject to Maine's income tax laws"); Or. Dep't of Revenue Substantial Nexus Guidelines, OR. ADMIN. R. 150-713.010 (rev. May 2008) ("[s]ubstantial nexus" "does not require a taxpayer to have a physical presence in Oregon" and "exists where a taxpayer regularly takes advantage of Oregon's economy to produce income for the taxpayer and may be established through the significant economic presence of a taxpayer in the state.").

C. Awaiting Congressional Action Would Be Futile

Review by this Court should not be further delayed based on a speculative hope that Congress might at some point decide to address the problem posed by the economic-nexus theory. Questions about the scope of state taxing powers under the Commerce Clause are ones "that Congress has the ultimate power to resolve" (*Quill*, 504 U.S. at 318),

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solely on having sales in California would appear to effectively adopt an 'economic nexus' standard for California.").

but Congress has shown no inclination to address the issue. Accordingly, this Court has both the authority and the responsibility to ensure compliance with its precedents, and it is not for the States to legislate away the bright-line physical-presence requirement. Rather, if States conclude that the physical-presence requirement should be abandoned (or limited only to certain taxes), they are free to present that argument to Congress through the ordinary political process.

In *MBNA*, the State argued that the Court should deny review in order to give Congress a chance to act. *See* Br. in Opp., No. 06-1228, at 17-18. But Congress still has not acted in the two years since denial of review in *MBNA*, while the States have increasingly violated the principles enunciated in *Quill*, exacerbating the problems created by the economic-nexus approach. In fact, in the 17 years since *Quill* invited congressional resolution of the scope of state taxing power over non-domiciliaries, Congress has not addressed the issue, indicating that there is no realistic prospect that Congress will do so in the foreseeable future.[14] This Court should take this opportunity to ensure that States, in their insatiable demand for more sources of revenue (particularly from politically disenfranchised out-of-state businesses), do not continue to defy the principles enunciated in *Quill* and *Bellas Hess*.

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[14] For example, although business-activity-tax simplification bills have been introduced in recent Congresses, no votes have ever been cast on the portions of such legislation addressing the scope of the physical-presence requirement. Business Activity Tax Simplification Act of 2009, H.R. 1083, 111th Cong. (2009); Business Activity Tax Simplification Act of 2007, S. 1726, 110th Cong. (2007); Internet Tax Fairness Act of 2001, H.R. 2526, 107th Cong. (2001); New Economy Tax Fairness Act, S. 664, 107th Cong. (2001).

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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March 19, 2009

APPENDIX

APPENDIX A

Supreme Judicial Court of Massachusetts,
Suffolk.

CAPITAL ONE BANK & another[1]

v.

COMMISSIONER OF REVENUE.

Argued Oct. 7, 2008.

Decided Jan. 8, 2009.

Present: MARSHALL, C.J., IRELAND, SPINA, COWIN, CORDY, & BOTSFORD, JJ.

SPINA, J.

The present appeal is from a decision of the Appellate Tax Board (board) affirming the denial by the Commissioner of Revenue (commissioner) of applications by the taxpayers, Capital One Bank (Capital One) and Capital One F.S.B. (FSB) (collectively, Capital banks), for the abatement of financial institution excises (FIET).[2] Capital One sought abate-

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1 Capital One F.S.B.

2 The Appellate Tax Board (board) noted that G.L. c. 63, § 2, imposes an excise, not a tax, on financial institutions. For an extensive discussion of the historical differences between a tax and an excise, *see* P. Nichols, Taxation in Massachusetts 15-17

[Footnote continued on next page]

ment for the tax years 1995 through 1998, and FSB sought abatement for the tax years 1996 through 1998. At issue is whether, consistent with the Federal commerce clause of the United States Constitution art. 1, § 8, the Commonwealth can impose the FIET, pursuant to G.L. c. 63, § 2, on financial institutions[3] that do not have a physical presence in Massachusetts. We granted the Capital banks' application for direct appellate review, and now affirm the board's decision.[4]

The board found the following facts, based on the parties' detailed stipulation of facts and the testimony and exhibits introduced at the hearing. *See* G.L. c. 58A, § 13 ("The decision of the board shall be final as to findings of fact"); *United Church of Religious Science v. Assessors of Attleboro*, 372 Mass. 280, 281, 361 N.E.2d 1254 (1977).

In 1994, Capital One was established as a wholly owned subsidiary of Capital One Financial Corpora-

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(3d ed. 938). Here, for consistency and ease of reference, we, like the parties and the board, shall refer to the excise at issue as the financial institution excise tax (FIET).

3 A "[f]inancial institution" includes "any bank, banking association, trust company, federal or state savings and loan association, including all banks for cooperatives organized under the United States Farm Credit Act of 1933, whether of issue or not, existing by authority of the United States, or any state, or a foreign country, or any law of the commonwealth." G.L. c. 63, § 1.

4 We acknowledge the amicus brief filed by Multistate Tax Commission in support of the board, and the amicus brief filed by the Council on State Taxation in support of Capital One Bank and Capital One F.S.B.

tion (COFC), a Delaware corporation. Capital One is a Virginia-chartered credit card bank that offers credit card products. FSB was established in 1996, also as a wholly owned subsidiary of COFC. It is a federally chartered savings bank that offers consumer lending and deposit products, including secured and unsecured credit cards, to individuals and small businesses. FSB also makes unsecured installment loans and has a consumer home loan business.

The commercial domicil for each bank is Virginia, where credit approval activities occurred. During the tax years at issue, the Capital banks neither owned nor leased any real property in the Commonwealth. Further, the board assumed, based on the record before it, that the Capital banks owned no other Massachusetts property,[5] and no employee, agent, or independent contractor of the Capital banks was located in Massachusetts during the tax years at issue. As credit card issuers doing business in the Commonwealth, the Capital banks had been required to file quarterly credit card issuer's reports

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5 The board noted that it was unclear whether credit card readers used by merchants were the property of the Capital banks, the merchants, or some other entity. Further, the record was not clear as to whether the cardholders, the Capital banks, or both had ownership of the credit cards themselves. The board stated that because its decision was not dependent on the Capital banks' ownership of property or other physical presence in Massachusetts, the ownership of the credit cards and the card readers was immaterial.

with the Massachusetts division of banks. *See* G.L. c. 140, § 114C, inserted by St.1987, c. 595, § 1.[6]

COFC is the owner of the trademark "Capital One," which it provided to the Capital banks, without license or royalty, for placement on their credit cards. Using a system called "Information-Based Strategy," which employs statistical modeling techniques to segment potential customer lists based on credit scores, demographics, and other characteristics, the Capital banks targeted specific potential customers nationwide, including customers in the Commonwealth. As pertinent here, the Capital banks then entered into agreements with Massachusetts residents for the issuance of "general purpose" credit cards branded with the "Capital One" trademark and the logo of either Visa U.S.A. Inc. (Visa), or MasterCard International (MasterCard).[7] Pursuant

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6 In 1996, the filing requirement for a credit card issuer's reports was changed from quarterly to semiannually. *See* St. 1996, c. 359, § 2. Subsequent legislation deleted this filing requirement from G.L. c. 140, § 114C, altogether. *See* St. 2002, c. 455, § 1.

7 Visa and MasterCard are structured as open associations whose members issue Visa-branded or MasterCard-branded payment cards, acquire merchants that will accept such payment cards, or do both. Visa and MasterCard provide services for their members, including the authorization, settlement, and clearance of transactions. With certain limited exceptions, Visa's membership is open to any institution that is eligible for Federal Deposit Insurance Corporation deposit insurance or share insurance. As of 2005, Visa had approximately 14,000 members in the United States, including over 12,000 Visa card issuers (and had similar membership numbers during the tax years at issue). MasterCard's membership is generally open to any organization that is authorized to engage in financial

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to these agreements, the Capital banks would advance funds on behalf of their customers for transactions in which the customers used a "Capital One" Visa-branded or MasterCard-branded credit card to make purchases of goods and services from merchants nationwide. The Capital banks also would allow customers to obtain cash advances at Capital banks nationwide displaying the Visa or MasterCard logo, or at bank automated teller machine (ATM) kiosks displaying the Visa or MasterCard logo, or at ATM kiosks displaying the PLUS or CIRRUS logo, if such logo also appeared on the credit card.[8] The Capital banks' customers agreed to repay the advanced funds, subject to finance charges and other fees set forth in their credit card agreements.

As members of the Visa and MasterCard associations, the Capital banks paid fees to those associations relating to credit card transactions nationwide, including transactions by the Capital banks' Massachusetts customers. In return, the Capital banks received numerous benefits from the Visa and MasterCard associations, including technology and equipment necessary to process credit card transactions. On a larger scale, the Capital banks were able to access a nationwide interconnected credit infrastruc-

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transactions under the laws or government regulations of the country in which it is organized or principally engaged in business, subject to additional requirements set out in MasterCard bylaws and rules.

8 The PLUS name is a trademark owned by Visa International Service Association and licensed to Visa. The CIRRUS name is a trademark owned by MasterCard.

ture that provided enormous value both to their own businesses and to the Capital banks' customers.

A typical credit card transaction proceeded as follows. When a Massachusetts customer presented a "Capital One" Visa-branded or MasterCard-branded credit card in payment for goods or services, the cardholder or merchant would "swipe" the card through a card reader located at the merchant's place of business. The credit card information would be relayed to an "acquiring bank" with which the merchant had contracted for the handling of credit card transactions. The acquiring bank verified, processed, and transmitted the credit card information to Visa or MasterCard, which, in turn, relayed the transaction information to the cardholder's "issuing bank" (here, the Capital banks), which then checked the cardholder's credit line and account status. Assuming that the cardholder had sufficient credit, the issuing bank approved the transaction, and such approval was sent by the issuing bank through the association network to the acquiring bank, which relayed the approval to the merchant at the point of sale. This process occurred in one rapid series of events. Subsequently, payment requests were sent by the merchant to the acquiring bank, which forwarded them to the issuing bank for reimbursement. The issuing bank paid the acquiring bank the amount requested, less an "interchange fee." The acquiring bank then retained its own processing fee from the amount received, and paid the remainder to the merchant.[9] During the tax years at

9 To put these fees in perspective, the board noted that in a typical Visa or MasterCard transaction, the issuing bank re-

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issue, the Capital banks received interchange fees related to Massachusetts customers ranging between $4.2 million and $6.8 million annually.

By issuing credit cards with the "Capital One" logo to Massachusetts customers, the Capital banks essentially were guaranteeing payment to merchants of the amounts charged by those customers, if approved. The Capital banks bore the risk of a cardholder's nonpayment. In the event of such nonpayment, the Capital banks worked with collection agencies[10] and Massachusetts attorneys to collect delinquent accounts, which included the filing of civil actions on behalf of the Capital banks in Massachusetts courts. When necessary, the Capital banks obtained garnishments or liens against their customers' personal property, and, on two occasions, secured writs of execution against Massachusetts real property. If legal proceedings were commenced in Virginia against Massachusetts residents under the Virginia long-arm statute, Va. Code Ann. § 8.01-328.1 (2007), the resulting judgments were, at times, domesticated to Massachusetts for further enforcement proceedings. In addition, the Massachusetts Attorney General's office, through its consumer com-

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tained an "interchange fee" of approximately 1.4 per cent of the transaction price, and the acquiring bank retained an additional fee of approximately .6 per cent. Consequently, a total of approximately 2.0 per cent of the transaction amount, known as the "merchant discount," would be paid to the issuing and acquiring banks. *See United States v. Visa U.S.A., Inc.*, 344 F.3d 229, 235 (2d Cir. 2003).

[10] None of the collection agencies used during the tax years at issue was located in Massachusetts.

plaints and information section, helped resolve disputes between the Capital banks and Massachusetts residents during the tax years at issue.

As a result of the Capital banks' marketing efforts in the Commonwealth, the number of Massachusetts residents carrying Capital One credit cards rose from 196,645 in 1995 to 465,571 in 1998, and the number of Massachusetts residents carrying FSB credit cards rose from 3,845 in 1996 to 7,363 in 1998. In total, the Capital banks spent more than $20 million, through its marketing efforts, to acquire Commonwealth residents as customers during the tax years at issue. Capital One's outstanding receivables from accounts held by Massachusetts cardholders grew from $72,162,796 in 1995 to $113,655,624 in 1998. FSB's outstanding receivables from accounts held by Massachusetts cardholders grew from $11,457,826 in 1996 to $16,588,914 in 1998. Capital One's income, derived from interest, fees, and penalties associated with the use of its credit cards by Massachusetts residents, rose from $22,319,653 in 1995 to $57,941,377 in 1998. FSB's income, derived from the same sources, rose from $1,534,525 in 1996 to $3,483,093 in 1998.

On February 28, 2000, in response to notification from the commissioner that they had not filed FIET returns for the tax years at issue, the Capital banks provided the Department of Revenue (department) with apportionment and other relevant information. On August 6, 2000, the department issued to the Capital banks separate notices of intention to assess, followed shortly thereafter by notices of assessment for the tax years at issue. The amounts of the assessments were $1,758,454 for Capital One, and $159,075.25 for FSB. The Capital banks filed timely applications for abatement of the FIET. *See* G.L. c.

62C, § 37. The commissioner denied the applications, and the Capital banks appealed to the board pursuant to G.L. c. 62C, § 39.

In affirming the commissioner's denial of the abatements, the board stated that the Capital banks' activities in Massachusetts constituted a "substantial nexus" with the Commonwealth that justified imposition of the FIET for the tax years at issue. In particular, the board based its determination on the Capital banks' purposeful, targeted marketing of their credit card business to Massachusetts customers; their required filing of quarterly credit card issuer's reports with the Massachusetts division of banks; their use of the Massachusetts court system and the Massachusetts Attorney General's office to collect delinquent accounts and resolve disputes; their use of sophisticated networks, including the Visa and MasterCard associations and Massachusetts acquiring banks, which linked the Capital banks with Massachusetts customers and merchants, and by which the Capital banks, through their customers' use of "Capital One" branded credit cards, guaranteed payment to the merchants on behalf of the customers; and their receipt of hundreds of millions of dollars in income from millions of transactions involving Massachusetts residents and merchants.[11] The board stated that, pursuant to its

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[11] The Capital banks contend that the record does not show that they actually filed any credit card issuer's reports with the Massachusetts division of banks or initiated contact with the Attorney General's office. The Capital banks may not, in fact, have filed any reports pursuant to G.L. c. 140 § 114C, but the statutory language suggests that they were required to do so. In addition, even if the Capital banks did not initiate any con-

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reading of *Quill Corp. v. North Dakota*, 504 U.S. 298, 112 S. Ct. 1904, 119 L.Ed.2d 91 (1992) (*Quill*), a financial institution's "physical presence" in the taxing State was not required to establish "substantial nexus" for purposes of the State's imposition of an income-based tax on that institution. Consequently, the board concluded that the Commonwealth's assessment of the FIET on the Capital banks was constitutional under the Federal commerce clause.[12]

A decision by the board will not be modified or reversed if the decision "is based on both substantial evidence and a correct application of the law." *Boston Professional Hockey Ass'n v. Commissioner of Revenue*, 443 Mass. 276, 285, 820 N.E.2d 792 (2005). We presume that a tax is constitutionally valid unless the party challenging it establishes its invalidity "beyond a rational doubt." *Andover Sav. Bank v. Commissioner of Revenue*, 387 Mass. 229, 235, 439 N.E.2d 282 (1982). While we give deference to the board's expertise in interpreting the tax laws of the Commonwealth, *see French v. Assessors of Boston*, 383 Mass. 481, 482, 419 N.E.2d 1372 (1981), we ap-

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tact with the Attorney General's office, Massachusetts consumers filed complaints against them with that office, and the Capital banks responded to those complaints.

12 The board also concluded that the privileges associated with the Capital banks' right to do business in Massachusetts and the Capital banks' sale of financial services in the Commonwealth were "commodities," and that the FIET was a "reasonable" excise on such commodities under the Massachusetts Constitution. *See* Part 2, c. 1, § 1, art. 4, of the Constitution of the Commonwealth. The Capital banks have not challenged this determination in the present appeal, so we need not consider it further.

ply our independent judgment as to both the law and the facts on constitutional issues. *See Opinion of the Justices*, 328 Mass. 679, 687, 106 N.E.2d 259 (1952).

The thrust of the Capital banks' appeal is that the board erroneously limited to the sales and use tax context the United States Supreme Court's holding in *Quill, supra* at 317-318, 112 S. Ct. 1904, that the Federal commerce clause precludes a State from imposing tax obligations on an out-of-State corporation that has no physical presence in the taxing State. In the Capital banks' view, this physical presence requirement should be equally applicable to a State's assessment of an income-based excise, like the FIET. The Capital banks contend that the board disregarded the reasons stated in *Quill* for upholding a "bright-line" test for tax liability and the benefits of such a clear standard. Contrary to the board's determination, the Capital banks continue, sales and use taxes do not impose a more significant burden on interstate commerce than income-based taxes such that the two types of taxes should be treated differently under the commerce clause. For these reasons, the Capital banks argue that the FIET should be deemed unconstitutional as inconsistent with the Federal commerce clause. We disagree.

Pursuant to G.L. c. 63, § 2, "every financial institution engaged in business in the commonwealth shall pay, on account of each taxable year, an excise measured by its net income determined to be taxable under [G.L. c. 63, § 2A,] at the [designated] rate."[13]

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[13] General Laws c. 63, § 2A (*b*), provides that "[i]f the financial institution has income from business activity which is taxable both within and without this commonwealth, its net in-

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The Capital banks have not asserted that they are not "financial institutions" for purposes of imposition of the FIET. *See* G.L. c. 63, § 1 (defining "[f]inancial institution"). As pertinent to the factual circumstances here, the phrase "engaged in business in the commonwealth" includes "regularly engaging in transactions with customers in the commonwealth that involve intangible property and result in income flowing to the taxpayer from residents of the commonwealth." *Id.* These activities "shall be presumed, subject to rebuttal, to be conducted on a regular basis within the commonwealth, if any of such activities are conducted with one hundred or more residents of the commonwealth during any taxable year or if the taxpayer has ten million dollars or more of assets attributable to sources within the commonwealth, or has in excess of five hundred thousand dollars in receipts attributable to sources within the commonwealth." *Id.* The Capital banks have challenged the imposition of the FIET only on constitutional grounds; they have not rebutted the statutory presumption that they have regularly engaged in business in Massachusetts.

A State's ability to tax businesses like the Capital banks, that operate in interstate commerce, "is constrained by the Federal government's broad power to regulate interstate commerce under the commerce clause."[14] *Aloha Freightways, Inc. v.*

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come shall be apportioned to this commonwealth by multiplying its net income by the apportionment percentage."

14 Because the Capital banks have challenged the constitutionality of the FIET under only the commerce clause, that is the focus of our consideration. Nonetheless, we point out that a

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Commissioner of Revenue, 428 Mass. 418, 421, 701

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State's ability to tax businesses operating in interstate commerce also is constrained by the due process clause of the Fourteenth Amendment to the United States Constitution. Although unconstitutional taxation claims under the due process and commerce clauses are closely related, *see National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U.S. 753, 756, 87 S. Ct. 1389, 18 L.Ed.2d 505 (1967), they are separate and "pose distinct limits on the taxing powers of the States." *Quill Corp. v. North Dakota*, 504 U.S. 298, 305, 112 S. Ct. 1904, 119 L.Ed.2d 91 (1992) (*Quill*). The due process clause and the commerce clause address different constitutional concerns. Due process focuses on "the fundamental fairness of governmental activity" and requires consideration "whether an individual's connections with a State are substantial enough to legitimate the State's exercise of power over him." *Id.* at 312, 112 S. Ct. 1904. Thus, the due process clause requires "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." *Miller Bros. v. Maryland*, 347 U.S. 340, 344-345, 74 S. Ct. 535, 98 L.Ed. 744 (1954). *See International Harvester Co. v. Wisconsin Dep't of Taxation*, 322 U.S. 435, 441-442, 64 S. Ct. 1060, 88 L.Ed. 1373 (1944) ("A state may tax such part of the income of a nonresident as is fairly attributable either to property located in the state or to events or transactions which, occurring there, are subject to state regulation and which are within the protection of the state and entitled to the numerous other benefits which it confers"). *See also Truck Renting & Leasing Ass'n v. Commissioner of Revenue*, 433 Mass. 733, 736, 746 N.E.2d 143 (2001). "In contrast, the Commerce Clause and its nexus requirement are informed not so much by concerns about fairness for the individual defendant as by structural concerns about the effects of state regulation on the national economy." *Quill, supra.* Consistent with the due process clause, a State may have the authority to impose a tax based on minimum contacts, but the imposition of such a tax may unconstitutionally burden interstate commerce because the taxpayer lacks a "substantial nexus" with the taxing State. *See id.* at 308, 313, 112 S. Ct. 1904.

N.E.2d 961 (1998). The commerce clause authorizes Congress to "regulate Commerce . . . among the several States." Art. 1, § 8. The United States Supreme Court has consistently held that the commerce clause includes "a further, negative command, known as the dormant Commerce Clause, prohibiting certain state taxation even when Congress has failed to legislate on the subject." *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 179, 115 S. Ct. 1331, 131 L.Ed.2d 261 (1995). *See Quill, supra* at 309-312, 112 S. Ct. 1904 (discussing evolution of dormant commerce clause).

Consistent with the commerce clause, a State may impose a tax on a business engaged in interstate commerce where the tax "[1] is applied to an activity with a substantial nexus with the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State." *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279, 97 S. Ct. 1076, 51 L.Ed.2d 326 (1977) (*Complete Auto*). *See Truck Renting & Leasing Ass'n v. Commissioner of Revenue*, 433 Mass. 733, 740, 746 N.E.2d 143 (2001). By permitting States to tax purely interstate commerce, the United States Supreme Court affirmed the principle that "interstate commerce may be made to pay its way." *Complete Auto, supra* at 281, 284, 97 S. Ct. 1076. *See Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 623624, 101 S. Ct. 2946, 69 L.Ed.2d 884 (1981), quoting *Colonial Pipeline Co. v. Traigle*, 421 U.S. 100, 108, 95 S. Ct. 1538, 44 L.Ed.2d 1 (1975) ("It was not the purpose of the commerce clause to relieve those engaged in interstate commerce from their just share of [the] state tax burden even though it increases the cost of doing business").

The Capital banks' challenge to the constitutionality of the FIET focuses solely on the first prong of the *Complete Auto* test, namely whether the Capital banks' activities had a "substantial nexus" with Massachusetts.[15] To satisfy this requirement, "[t]he business must have some constitutionally sufficient degree of contact with the taxing State before the State can impose any tax on it." *Aloha Freightways, Inc. v. Commissioner of Revenue, supra.* It is a standard that is designed to prevent overreaching by States. *Id.* at 423, 701 N.E.2d 961. "[T]he 'substantial nexus' requirement is not, like due process' 'minimum contacts' requirement, a proxy for notice, but rather a means for limiting state burdens on interstate commerce." *Quill, supra* at 313, 112 S. Ct. 1904.

The roots of a "physical presence" requirement under commerce clause analysis were firmly established in *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U.S. 753, 87 S. Ct. 1389, 18 L.Ed.2d 505 (1967) (*Bellas Hess*), which involved a constitutional challenge to a State's assessment of a use tax on goods purchased for use in the taxing State from an out-of-State mail order merchant that had no in-State retail outlets, sales representatives, or property. The United States Supreme Court concluded that a State's assessment of a use tax in such circumstances created an unconstitutional burden on interstate commerce because the merchant's only

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[15] Because the Capital banks' challenge to the constitutionality of the FIET under the commerce clause pertains only to the first prong of the *Complete Auto* test, we limit our discussion to that requirement.

connections with the taxing State were by mail or common carrier. *Id.* at 758-759, 87 S. Ct. 1389. The Court's reasoning for its decision was based, in significant part, on the fact that the many local variations in rates of use tax, in allowable exemptions, and in administrative requirements would impede the free conduct of interstate business. *Id.* at 759-760, 87 S. Ct. 1389. The very purpose of the commerce clause, the Court stated, "was to ensure a national economy free from such unjustifiable local entanglements." *Id.* at 760, 87 S. Ct. 1389.

Twenty-five years later, the United States Supreme Court reaffirmed in *Quill, supra* at 317-318, 112 S. Ct. 1904, that, with respect to the imposition of sales and use taxes, the constitutionally sustainable measure of contact required for substantial nexus under the commerce clause was "physical presence" in the taxing State. The Court made a point of stating that "[w]hile contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today," *id.* at 311, 87 S. Ct. 1389, the *Bellas Hess* bright-line physical presence requirement was not inconsistent with the four-part *Complete Auto* test, which the Court described as "continu[ing] to govern the validity of state taxes under the Commerce Clause." *Quill, supra* at 310, 112 S. Ct. 1904. Nothing, however, in *Quill* suggested that physical presence is required for the imposition of other types of taxes, including an income-based excise such as the FIET. To the contrary, while not repudiating the *Bellas Hess* rule, the Supreme Court stated in Quill that it had not, "in [its] review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes." *Id.* at 314, 112 S. Ct. 1904 (stating that

Court's commerce clause jurisprudence "now favors more flexible balancing analyses"). Moreover, when summarizing the precedent established in *Bellas Hess*, the Court reiterated that, in cases "subsequent to *Bellas Hess* and concerning other types of taxes, [it had] not adopted a similar bright-line, physical-presence requirement." *Id.* at 317, 87 S. Ct. 1389. *See Truck Renting & Leasing Ass'n v. Commissioner of Revenue*, *supra* at 740 n. 13, 746 N.E.2d 143 (noting that, in *Quill*, Supreme Court did not extend physical presence requirement for imposition of use or sales tax on out-of-State vendor to other types of taxes). *Cf. Borden Chems. & Plastics v. Zehnder*, 312 Ill.App.3d 35, 44, 244 Ill.Dec. 477, 726 N.E.2d 73 (2000) (declining to extend *Quill*'s physical presence requirement to income-based taxation, but recognizing that such requirement would have been satisfied by taxpayer at issue); *Couchot v. State Lottery Comm'n*, 74 Ohio St.3d 417, 425, 659 N.E.2d 1225, *cert. denied*, 519 U.S. 810, 117 S. Ct. 55, 136 L.Ed.2d 18 (1996) (same).

The language of the Supreme Court's decision in *Quill* explicitly emphasized, on more than one occasion, a narrow focus on sales and use taxes for the physical presence requirement, and suggested that this requirement was limited to those specific assessments and did not apply to the imposition of other types of State taxes. We will not expand the Court's reasoning beyond its articulated boundaries, particularly where the Court, itself, has limited its holding to a particular form of taxation.

In a case similar to the present one, the West Virginia Supreme Court of Appeals considered in *Tax Comm'r of W. Va. v. MBNA Am. Bank, N.A.*, 220 W.Va. 163, 164-166, 640 S.E.2d 226 (2006), *cert. denied sub nom. FIA Card Services, N.A. v. Tax*

Comm'r of W. Va., ___ U.S. ___, 127 S. Ct. 2997, 168 L.Ed.2d 719 (2007) (*MBNA*), whether imposition of that State's business franchise and corporation net income taxes on MBNA America Bank, a Delaware corporation with no physical presence in West Virginia, violated the substantial nexus requirement of the commerce clause. The principal business of MBNA America Bank was issuing and servicing Visa and MasterCard credit cards, which it promoted in West Virginia by mail and telephone solicitation. *Id.* at 164, 640 S.E.2d 226. After considering the evolution of the Supreme Court's interpretation of the dormant commerce clause, the court in *MBNA* concluded that "*Quill's* physical-presence requirement for showing a substantial Commerce Clause nexus applie[d] only to use and sales taxes and not to business franchise and corporation net income taxes." *Id.* at 169, 640 S.E.2d 226.[16]

In reaching its conclusion, the West Virginia Supreme Court of Appeals opined that (1) the United States Supreme Court's decision in *Quill* was based

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16 Contrast *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831, 842 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927, 121 S. Ct. 305, 148 L.Ed.2d 245 (2000) (stating that, while it was not court's purpose "to decide whether 'physical presence' is required under the Commerce Clause," lack of substantial nexus did not justify assessment of franchise and excise taxes on out-of-State credit card company), questioned in *America Online, Inc. v. Johnson*, No. M2001-00927COA-R3-CV, 2002 WL 1751434 (Tenn. Ct. App. July 30, 2002) (noting that in *J.C. Penney Nat'l Bank v. Johnson*, *supra*, it might have been more accurate for court to say that "the Supreme Court had rejected state taxes on interstate commerce where no activities had been carried on in the taxing state *on the taxpayer's behalf*" [emphasis in original]).

primarily on *stare decisis* and on the fact that the precedent established in *Bellas Hess* had engendered substantial reliance by the mail order industry, circumstances that did not compel application beyond the context of sales and use taxes; (2) the Supreme Court appeared to have expressly limited the scope of *Quill* to sales and use taxes; and (3) the Supreme Court's decisions in *Bellas Hess* and *Quill* were based, in part, on the fact that compliance with specific administrative regulations associated with the collection of sales and use taxes unduly burdened interstate commerce, but that the collection of franchise and income taxes did not appear to cause similar compliance burdens.[17] *Id.* at 169-170, 640 S.E.2d

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[17] Contrary to the Capital banks' assertion, the board's finding that sales and use taxes impose special burdens on interstate commerce was not based on faulty logic. In its discussion of these burdens with respect to an out-of-State mail order company, the United States Supreme Court observed in *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U.S. 753, 759, 87 S. Ct. 1389, 18 L.Ed.2d 505 (1967), that if one State can impede "the free conduct of [such company's] interstate business," then "so can every other State, and so, indeed, can every municipality, every school district, and every other political subdivision throughout the Nation with power to impose sales and use taxes." As a result, the Court stated, "[t]he many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements could entangle [the mail order company] in a virtual welter of complicated obligations to local jurisdictions with no legitimate claim to impose 'a fair share of the cost of the local government.'" *Id.* at 759-760, 87 S. Ct. 1389, quoting *Freeman v. Hewit*, 329 U.S. 249, 253, 67 S. Ct. 274, 91 L.Ed. 265 (1946). Similarly, in *Quill*, *supra* at 313 n. 6, 112 S. Ct. 1904, the Supreme Court noted that upholding one State's imposition of a use tax on an out-of-State mail order company could unduly burden interstate com-

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226. The court further stated that the physical presence test "makes little sense in today's world" where, for example, "electronic commerce now makes it possible for an entity to have a significant economic presence in a state absent any physical presence there."[18] *Id.* at 171, 640 S.E.2d 226. The analysis set forth in *MBNA* is persuasive.[19]

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merce where "similar obligations might be imposed by the Nation's 6,000-plus taxing jurisdictions." Such burdens associated with the imposition of sales and use taxes are not inconsequential. An income-based excise, on the other hand, typically is paid only once a year (except when quarterly estimated taxes are required), to one taxing jurisdiction at the State level, and the payment of such an excise does not entail collection obligations vis-à-vis consumers. *See Tax Comm'r of W. Va. v. MBNA Am. Bank, N.A.*, 220 W.Va. 163, 170-171, 640 S.E.2d 226 (2006), *cert. denied sub nom. FIA Card Servs., N.A. v. Tax Comm'r of W. Va.*, ___ U.S. ___, 127 S. Ct. 2997, 168 L.Ed.2d 719 (2007). Determinations about whether the Capital banks are subject to the FIET, in the first instance, and how to apportion income from business activity that is taxable within the Commonwealth are the sorts of decisions that, more broadly, can confront all taxpayers, local or out-of-State, when calculating, reporting, and paying taxes on their income. While the making of these determinations is certainly more complex for large corporate taxpayers, it is part of the cost of doing business and is not, in our opinion, unduly burdensome on interstate commerce, particularly where such taxpayers, like the Capital banks, are earning substantial income from their business activities in Massachusetts and where the common usage of computer technology and specialized software has eased the administrative burdens of tax compliance.

18 In a separate opinion in *Quill*, Justice White stated: "Perhaps long ago a seller's 'physical presence' was a sufficient part of a trade to condition imposition of a tax on such presence. But in today's economy, physical presence frequently has very little

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Like the West Virginia court, we conclude that the constitutionality, under the commerce clause, of the Commonwealth's imposition of the FIET is de-

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to do with a transaction a State might seek to tax. Wire transfers of money involving billions of dollars occur every day; purchasers place orders with sellers by fax, phone, and computer linkup; sellers ship goods by air, road, and sea through sundry delivery services without leaving their place of business.... [A]n out-of-state direct marketer derives numerous commercial benefits from the State in which it does business [and the Court should not, under the commerce clause,] attempt to justify an anachronistic notion of physical presence in economic terms." *Quill*, *supra* at 327-328, 112 S. Ct. 1904 (White, J., concurring in part and dissenting in part). This observation is even more true today than it was in 1992.

19 In its determination, the board cited several post-*Quill* decisions that upheld the imposition of income-based taxes on out-of-State corporations that had no tangible physical presence in the taxing State. *See, e.g., Geoffrey, Inc. v. South Carolina Tax Comm'n*, 313 S.C. 15, 23-24 & n. 4, 437 S.E.2d 13, *cert. denied*, 510 U.S. 992, 114 S. Ct. 550, 126 L.Ed.2d 451 (1993) (stating that *Quill* did not extend physical presence requirement beyond sales and use taxes, and concluding that licensing intangible property for use in taxing State established substantial nexus for imposition of income-based tax). *See also Lanco, Inc. v. Director, Div. of Taxation*, 188 N.J. 380, 383, 908 A.2d 176 (2006) (*per curiam*), *cert. denied*, ___ U.S. ___, 127 S. Ct. 2974, 168 L.Ed.2d 702 (2007); *Kmart Props., Inc. v. Taxation & Revenue Dep't*, 139 N.M. 177, 185-186, 131 P.3d 27 (Ct. App. 2001), *rev'd on other grounds*, 139 N.M. 172, 131 P.3d 22 (2005); *A & F Trademark, Inc. v. Tolson*, 167 N.C.App. 150, 159-163, 605 S.E.2d 187 (2004), *cert. denied*, 546 U.S. 821, 126 S. Ct. 353, 163 L.Ed.2d 62 (2005). While these cases are instructive with respect to their analysis of *Quill*, they are not directly on point factually, because all involved foreign corporations with intangible property (trademarks, trade names, and service marks) that was being used in the taxing State by a licensee.

termined not by *Quill's* physical presence test, but by the "substantial nexus" test articulated in *Complete Auto*. Accordingly, we turn to the facts of the present case to determine whether Capital One and FSB had a substantial nexus with this Commonwealth during the tax years at issue.

While the concept of "substantial nexus" is more elastic than "physical presence," it plainly means a greater presence, both qualitatively and quantitatively, than the minimum connection between a State and a taxpayer that would satisfy a due process inquiry. *See* note 14, *supra*. Simply put, the test is "substantial" nexus, not "minimal" nexus. In addition to their consumer lending activities, the Capital banks were soliciting and conducting significant credit card business in the Commonwealth with hundreds of thousands of Massachusetts residents, generating millions of dollars in income for the Capital banks. In essence, the Capital banks were providing valuable financial services to Massachusetts consumers, for which the Capital banks were compensated in the form of interest payments, interchange fees, and finance charges. They could not provide such services in the Commonwealth without using Massachusetts banking and credit facilities. In addition, the Capital banks addressed customer complaints with the assistance of the Massachusetts Attorney General's office, and, when necessary, they used the Massachusetts court system to recover payment for delinquent accounts. Based on the findings of the board, we conclude that the Capital banks' activities in Massachusetts established a substantial nexus with the Commonwealth and, therefore, the assessment of the FIET on the Capital banks comported with the Federal commerce clause.

Decision of the Appellate Tax Board affirmed.

APPENDIX B

Appellate Tax Board
Commonwealth of Massachusetts

**CAPITAL ONE BANK
AND CAPITAL ONE F.S.B.**

v.

COMMISSIONER OF REVENUE

Docket Nos. C262391 & C262598

June 22, 2007

FINDINGS OF FACT AND REPORT

In these appeals, the appellants, Capital One Bank ("COB") and Capital One F.S.B. ("FSB" and, together with COB, the "Banks"), challenge the constitutionality of the financial institution excise ("FIET")[1] and the determination of the appellee Commissioner of Revenue ("Commissioner") that the Banks' in-state activities constituted substantial

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1 Both parties adopted the acronym "FIET" for the excise at issue, based on their description of the excise as the "financial institution excise tax." The Board notes that G.L. c. 63, 2 imposes an excise, not a tax, on financial institutions. *See* P. NICHOLS, TAXATION IN MASSACHUSETTS 16 (3rd ed. 1938). For consistency and ease of reference, however, the Board also refers to the excise as the "FIET."

nexus with the Commonwealth of Massachusetts justifying the imposition of the FIET on them.

On the basis of the parties' detailed Stipulation of Facts, exhibits and the testimony introduced at the hearing of these appeals, the Appellate Tax Board ("Board") made the following findings of fact.

I. JURISDICTION

In response to a notification from the Commissioner that they had not filed FIET returns for the years at issue, the Banks provided the Commissioner with apportionment and other relevant information on or about February 28, 2000. The Commissioner issued separate Notices of Intention to Assess to COB and FSB on August 6, 2000. The Commissioner then issued Notices of Assessment dated September 6, 2000 and September 12, 2000, to COB and FSB, respectively. The amounts of the assessments at issue in these appeals are $1,758,454.96 for COB and $159,075 for FSB.

The Banks timely filed applications for abatement of the FIET with the Commissioner on July 10, 2001, which he denied on July 20, 2001. The Banks then timely filed their appeals with the Board on September 17, 2001. On the basis of the foregoing, the Board found and ruled that it had jurisdiction to hear and decide these appeals.

II. THE BANKS' MASSACHUSETTS BUSINESS

At all material times,[2] COB was a Virginia chartered credit card bank offering credit card products.

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[2] Unless explicitly stated otherwise, all factual findings relate to the years at issue.

It was established in 1994 as a wholly-owned subsidiary of Capital One Financial Corporation ("COFC"), which is a Delaware corporation. COB's commercial domicile was in Virginia, where credit approval activity took place.

FSB was a federally chartered savings bank that offered consumer lending and deposit products, including secured and unsecured credit cards, to individuals and small businesses. FSB also made unsecured installment loans and had a consumer home loan business. It was established in 1996 as a wholly-owned subsidiary of COFC.

COFC was the owner of the trademark "Capital One" and provided the trademark to the Banks, without license or royalty, to appear on credit cards which the Banks issued to customers in Massachusetts.

As credit card companies doing business in Massachusetts, the Banks were required to file quarterly credit card issuer's reports with the Massachusetts Division of Banks.

During the years at issue, the Banks' primary assets consisted of consumer loans using Capital One credit cards as the credit extension vehicle. The Banks also issued certificates of deposit and accepted secured credit card savings deposits. Both COB and FSB generated interest and other income through finance charges assessed on outstanding loan receivables, fees from credit card transactions described below, and interest earned on investment securities and money market investments.

Using a system called Information-Based Strategy ("IBS"), which used statistical modeling techniques that segment potential customer lists based on credit scores, demographics, and other character-

istics, the Banks targeted specific potential consumers in Massachusetts. As a result of the Banks' marketing efforts in Massachusetts, the number of Massachusetts residents carrying COB credit cards rose from slightly fewer than 200,000 to more than 460,000 during the years at issue and FSB's Massachusetts customers rose from less than 4,000 to more than 7,000 during that period. The Banks acknowledged spending between $50 and $100 per individual cardholder on marketing; at more than 400,000 cardholders in Massachusetts, the Banks spent an estimated $20 million-plus to acquire Massachusetts residents as customers during the periods at issue.

The acquisition of Massachusetts customers has resulted in millions of dollars in income to the Banks; COB's receivables related to Massachusetts customers grew from $72,162,796 to $113,655,624 during the years at issue, while FSB's receivables from Massachusetts accounts grew from $11,457,826 to $16,588,914. COB's income from Massachusetts customers rose from $22,319,653 in 1995 to $57,941,377 in 1998, while FSB's Massachusetts income rose from $1,534,525 in 1996 to more than $3,000,000 in both 1997 and 1998.

The Banks entered into agreements with Massachusetts residents for purposes of issuing "general purpose" credit cards branded with the Capital One trademark and the logo of either Visa or MasterCard. Visa and MasterCard are associations whose members issued credit cards with the association's logo, acquired merchants that accepted the association's credit cards, or both. Visa and MasterCard provided services for their members, including the authorization, settlement and clearance of transactions.

Under the credit card agreement, the Banks agreed to advance funds on behalf of their customers for transactions in which the customer used the "Capital One" Visa-branded credit card or the "Capital One" MasterCard-branded credit card to make purchases of goods and/or services from merchants or other service providers nationwide. The Banks also agreed to allow customers to obtain cash advances at banks nationwide displaying the Visa or MasterCard logo or at bank automated teller machines ("ATMs") displaying the Visa or MasterCard logo, or at ATMs displaying the PLUS or CIRRUS logo, if the logo also appeared on the card.[3]

The Banks were members of the Visa and MasterCard associations and paid them fees relating to credit card transactions nationwide, including those relating to credit card transactions engaged in by the Banks' Massachusetts customers. As members of the Visa and MasterCard associations, the Banks received numerous benefits, including technology and equipment necessary to process credit transactions. As members, the Banks were able to tap into a nationwide interconnected infrastructure that provided enormous value to their business and their customers, who received a credit card that could be used virtually anywhere, including within the Commonwealth.

A typical credit card transaction proceeds as follows. When a customer presents a credit card in payment for goods or services, the cardholder or mer-

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[3] The PLUS name is a trademark owned by Visa International Service Association and licensed to Visa. The CIRRUS name is a trademark owned by MasterCard.

chant typically "swipes" the card through a card-reader located at the merchant's place of business. The credit card information is relayed to an "acquiring bank" with which the merchant has contracted. The acquiring bank processes, packages and transmits that information to the Visa, MasterCard or other association network. The association network then relays the transaction information to the cardholder's "issuing bank," in this case, the Banks. The issuing bank approves the transaction assuming the cardholder has a sufficient credit line and the approval is sent by the issuing bank via the network to the acquiring bank, which relays the approval to the merchant. Payment requests are sent by the merchant to the acquiring bank, which forwards the request to the issuing bank. The issuing bank then pays the acquiring bank the amount requested, less what is called an "interchange fee." The acquiring bank then retains its own fee from the amount received, and pays the remainder to the merchant.[4] During the years at issue, the Banks received interchange fees related to Massachusetts customers ranging between $4.2 million and $6.8 million annually.

As issuing banks, the Banks bore the risk of the cardholder's non-payment. The Banks billed their customers, including Massachusetts customers, di-

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[4] In a typical Visa or MasterCard transaction, the acquiring bank retains 1.4 percent of the purchase price as an interchange fee and the issuing bank 0.6 percent as its fee; accordingly, a total of 2.0 percent of the merchant's sale price, known as the "merchant discount," is paid to the issuing and acquiring banks. *See United States of America v. Visa, U.S.A.*, 344 F.3d 229, 235 (2d Cir. 2003).

rectly and the cardholders had a number of days to pay the statement in full. Interest was charged on unpaid balances at a rate set by the Banks in their contracts with customers. By issuing credit cards with the "Capital One" logo to Massachusetts customers, the Banks were essentially guaranteeing payment to merchants of the amounts charged by the Banks' customers.

In the event of non-payment by its customers, the Banks worked with collection agencies and attorney networks to collect delinquent accounts. These agencies and attorneys provided collection services to the Banks related to their Massachusetts customers, and instituted legal proceedings on behalf of the Banks in Massachusetts courts. Capital One Services, Inc. ("COSI"),[5] a subsidiary of COFC that provided advertising, marketing, administrative and management services to the Banks, engaged Massachusetts attorneys to bring actions against customers in default on behalf of the Banks.

In furtherance of the Banks' collection efforts in Massachusetts, the Banks obtained garnishments or liens against personal property and secured writs of execution against Massachusetts real estate. If court actions were brought in Virginia against Massachusetts residents under the Virginia long-arm statute, those judgments were at times domesticated to Mas-

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[5] Another COFC subsidiary, Oakstone Ventures, Inc, was created to identify non-bank business opportunities because the Banks were prohibited from engaging in such activities. Beginning in 1998, Oakstone had an office in Boston, Massachusetts and an Oakstone employee participated in discussions with the Banks concerning strategies for the provision of financial services, including credit card strategies, in Massachusetts.

sachusetts for further enforcement proceedings. The Massachusetts Attorney General's Office also helped mediate disputes between the Banks and Massachusetts residents during the years at issue, offering assistance through its Consumer Complaints and Information Section and nineteen Local Consumer Programs located throughout Massachusetts.

The Banks neither owned nor leased real property in Massachusetts. Further, the Board assumes on this record that the Banks owned no other Massachusetts property[6] and no Bank employee, agent or independent contractor[7] was located in Massachusetts during the years at issue.

The Board found and ruled that the Banks' activities constituted "substantial nexus" with Massachusetts so as to justify imposition of the FIET, irrespective of whether the Banks had a physical presence in Massachusetts during the years at issue. The Banks' purposeful, targeted marketing of their

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6 It is unclear on the present record whether the card readers used at the merchant locations were the property of the Banks, the merchant, or some other entity. Further, the record is not clear as to whether the card holders or the Banks or both had an ownership in the credit cards themselves. Because the Board's ruling in these appeals is not dependant on the Bank's ownership of property or other physical presence in the Commonwealth, the ownership of the card reader and cards is immaterial.

7 The Banks argue that the collection activities of their independent contractors dis not establish physical presence because they are *de minimis* and they did not "expand the market" for the Banks' business. Again, because the Board's ruling of substantial nexus is not dependant on physical presence, resolution of this issue is not necessary.

credit card business to Massachusetts customers, their required quarterly filing of Credit Card Issuer's Reports with the Massachusetts Division of Banks, their use of Massachusetts court system and the Massachusetts Attorney General's Office to collect delinquent accounts and resolve disputes with Massachusetts customers, their use of a sophisticated network, including Visa and MasterCard as well as Massachusetts acquiring banks, which linked them with Massachusetts customers and merchants and by which they, through the customers' use of "Capital One"-branded cards, guaranteed payment to the merchant on behalf of the customer, and their deriving of hundreds of millions of dollars in income from millions of transactions involving Massachusetts residents and merchants constituted substantial nexus with Massachusetts.

The Board further found and ruled that the privileges related to the Banks' right to do business and its sale of financial services in the Commonwealth is a "commodity" and the FIET is a "reasonable excise" upon that commodity for purposes ofthe Massachusetts Constitution.

Accordingly, for all of the foregoing reasons, the Board issued decisions for the appellee in these appeals.

OPINION

These appeals raise the issue of whether, as a matter of law, the Commerce Clause of the United States Constitution (U.S. CONST. art. I, § 8, cl. 3, hereafter "Commerce Clause") requires that a corporation must have a "physical presence" in a state before that state may impose an excise measured by the corporation's net income. The Banks also argue that the FIET is an unreasonable, and therefore in-

valid, excise under MASSACHUSETTS CONST. Pt. II, C. 1, § 1, Art. 4.

The Board's authority to rule on constitutional claims in determining the legality of tax assessments is clear. *See, e.g. WB&T Mortgage Company Inc. v. Assessors of Boston*, ATB Findings of Fact and Report 2006-379; *Mullins v. Commissioner of Revenue*, ATB Findings of Fact and Reports 1997-973, *aff'd*, 428 Mass. 406 (1998); *Gillette Co. v. Commissioner of Revenue*, ATB Findings of Fact and Reports 1996-362, *aff'd*, 425 Mass. 670 (1997); *Lonstein v. Commissioner of Revenue*, ATB Findings of Fact and Reports 1988-355, *aff'd*, 406 Mass. 92 (1989); *Tregor v. Assessors of Boston*, ATB Findings of Fact and Reports 1978-203, *aff'd*, 377 Mass. 602 (1979).

In fact, a taxpayer must raise a constitutional claim with the Board to preserve the right to appellate consideration of the issue. *New Bedford Gas & Electric Light Co. v. Assessors of Dartmouth*, 368 Mass. 745, 752 (1975) ("To raise a constitutional question on appeal to this court from the board, the taxpayer must present the question to the board and, in so doing, make a proper record on appeal. Otherwise, the taxpayer waives the right to press the constitutional argument."). Accordingly, the Board has jurisdiction to determine whether the FIET assessed to the Banks is unconstitutional.

In determining whether the FIET is constitutional, the Board's analysis must be guided by the principle that "[a] tax measure is presumed valid and is entitled to the benefit of any constitutional doubt, and the burden of proving its invalidity falls on those who challenge the measure." *Opinion of the Justices*, 425 Mass. 1201, 1203-1204 (1997) (quoting *Daley v. State Tax Commission*, 376 Mass. 861, 865-66

(1978)); *see also Andover Savings Bank v. Commissioner of Revenue*, 387 Mass. 229, 235 (1982). Accordingly, the following analysis proceeds from the presumption that the FIET is valid and that any doubts concerning its interpretation must be resolved in favor of an interpretation that renders it constitutional.

The Board's analysis begins with a review of the FIET statute, followed by a discussion of relevant federal, Massachusetts and other state cases concerning the taxation of interstate commerce under the Commerce Clause, and concludes with a review of the Massachusetts constitutional requirements concerning reasonable excises.

I. MASSACHUSETTS TAXATION OF FINANCIAL INSTITUTIONS

Under G.L. c. 63, § 2, "every financial institution engaged in business in the commonwealth shall pay, on account of each taxable year, an excise measured by its net income determined to be taxable under section two A at the [designated rate]." The Banks do not challenge that they are financial institutions for purposes of § 2 and the remainder of the FIET.

For purposes of the FIET, "engaged in business" is defined in G.L. c. 63, § 1 as:

> (a) having a business location in the commonwealth; (b) having employees, representatives or independent contractors conducting business activities on its behalf in the commonwealth; (c) maintaining, renting or owning any tangible or real property in the commonwealth; ***(e) regularly engaging in transactions with the customers in the commonwealth that involve intangible property and result in income flowing to***

the taxpayer from residents of the commonwealth; (f) regularly receiving interest income from loans secured by tangible personal or real property located in the commonwealth; or (g) regularly soliciting and receiving deposits from customers in the commonwealth. ***With respect to the activities described in clauses (d) to(g), inclusive, activities shall be presumed, subject to rebuttal, to be conducted on a regular basis within the commonwealth, if any of such activities are conducted with one hundred or more residents of the commonwealth during any taxable year or if the taxpayer has ten million dollars or more of assets attributable to sources within the commonwealth, or has in excess of five hundred thousand dollars in receipts attributable to sources within the commonwealth.***

The Commissioner relies upon the highlighted subdivision (e), *i.e.* the Banks were regularly engaged in transactions with Massachusetts customers that involve intangible property and resulted in income flowing to the taxpayer from Massachusetts residents and the highlighted presumption that a financial institution that engaged in transactions with one hundred or more Massachusetts residents, had $10 million or more of assets attributable to Massachusetts sources, or had receipts exceeding $500,000 attributable to Massachusetts sources, for his determination that the Banks were "engaged in business" in, and had nexus with, Massachusetts.

The Banks do not contest that they fall within the explicit terms of the FIET. Rather, they maintain that the Commerce Clause requires their physi-

cal, as opposed to economic, presence in the Commonwealth in order to be subject to a tax measured by their net income.

II. CONSTITUTIONALITY OF FIET UNDER THE COMMERCE CLAUSE

Constitutional limitations on a state's power to tax interstate commerce stem from both the Due Process Clause (U.S. CONST. amend. XIV, § 1, hereafter the "Due Process Clause") and the Commerce Clause. Each clause "reflect[s] different constitutional concerns. Moreover, while Congress has plenary power to regulate commerce among the States and thus may authorize actions that burden interstate commerce... it does not similarly have the power to authorize violations of the Due Process Clause." *Quill Corp. v. North Dakota*, 504 U.S. 298, 305 (1992).

In the context of taxation, "to survive due process scrutiny, there must be 'some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax.'" *Truck Renting and Leasing Ass'n v. Commissioner of Revenue*, 433 Mass. 733, 736 (2001) (quoting *Horst v. Commissioner of Revenue*, 389 Mass. 117, 182 (1983)). Additionally, the "income attributed to the State for tax purposes must be rationally related to 'values connected with the taxing State.'" *Id.* (quoting *Quill*, 504 U.S. at 306). At the center of Due Process jurisprudence lies a concern for the "fundamental fairness of government activity." *Quill*, 504 U.S. at 312.

The Banks have not challenged the FIET as violative of the Due Process Clause, nor could they realistically have mounted such a challenge because Massachusetts "has provided the source [for the in-

come at issue] by providing and maintaining the economic setting out of which [the Banks reap their] profit." *Truck Renting*, 433 Mass. at 739 (quoting *American Refrigerator Transit Co. v. State Tax Comm'n*, 395 P.2d 127, 131 (Or. 1964).

Unlike the Due Process Clause, the Commerce Clause is "informed 'by structural concerns about the effects of state regulation on the national economy' and, specifically, any burden on interstate commerce caused by a State tax obligation" rather than fairness for the individual entity that is taxed. *Truck Renting*, 433 Mass. at 740 (quoting *Quill*, 504 U.S. at 312). Accordingly, the Commerce Clause's "substantial nexus requirement is not, like due process' minimum contacts requirement, a proxy for notice but rather a means for limiting state burdens on interstate commerce." *Quill*, 504 U.S. at 313.

A state may, consistent with the Commerce Clause, impose a tax on a company engaged in purely interstate commerce provided that the tax: "[1] is applied to an activity with a substantial nexus with the taxing state, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, [4] and is fairly related to the services provided by the State." *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). In permitting states to tax purely interstate commerce, *Complete Auto* overruled the *Spector Motor Services, Inc. v. O'Connor*, 340 U.S. 602 (1951) and *Freeman v. Hewitt*, 329 U.S. 249 (1946), line of cases, thus reaffirming the principle that "interstate commerce may be made to pay its way." *Complete Auto*, 430 U.S. at 284, 289 n.15. Massachusetts has consistently applied the Complete Auto test. *See Aloha Freightways, Inc. v. Commissioner of Revenue*, 428 Mass. 418, 421 (1998); *Truck Renting*, 433 Mass. at 740.

The Banks' principal challenge to the constitutionality of the FIET is the first or "substantial nexus" prong of *Complete Auto*.[8] "The 'substantial nexus' requirement 'seeks to prevent overreaching by States, and limits a State's ability to tax businesses operating within interstate commerce which lack a sufficient connection to the taxing state.'" *Truck Renting*, 433 Mass. at 740 (quoting *Aloha Freightways*, 428 Mass. at 423). To satisfy the "substantial nexus" requirement, the "business must have some constitutionally significant degree of contact with the taxing State before the State can impose any tax on it." *Aloha Freightways*, 428 Mass. at 421.

In *Quill*, the Supreme Court revisited the issue of substantial nexus in the context of a mail-order company's duty to collect use tax. *Quill*, 504 U.S. at 301. The taxpayer in *Quill* was an out-of-state mail order house "'whose only connection with customers in the State [was] by common carrier or the United States mail.'" *Id.* (quoting *National Bellas Hess* 386 U.S. 753, 758 (1967)). The Supreme Court of North Dakota had declined to follow *National Bellas Hess*, a case with similar facts and issues as in *Quill*, finding the holding "obsolete" under evolving Supreme Court Due Process and Commerce Clause jurisprudence. *Quill*, 504 U.S. at 310-12. Though the Court agreed "with much of the state court's reasoning" (*Id.* at 302) and acknowledged that Due Process Clause concerns were satisfied (*Id.* at 308), it reversed the

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8 The Banks raise only the "substantial nexus" prong in their Petitions to this Board. Although the Banks' brief makes oblique reference to the remaining prongs, the Banks offered no evidence or cogent argument that the FIET fails under prongs two through four of Complete Auto.

state court, reaffirming *National Bellas Hess* and finding insufficient nexus due to the taxpayer's lack of physical presence in the state. *Id.* at 318-19.

In preserving the *National Bellas Hess* bright-line physical presence test as to the duty to collect sales and use taxes, the Court in *Quill* observed that "contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today" and invited Congress to "decide whether, when, and to what extent the States may burden interstate mail-order concerns with a duty to collect taxes." *Id.* at 311 and 318. While it followed *National Bellas Hess* on principles of *stare decisis*, noting in particular that the *National Bellas Hess* physical presence rule "has engendered substantial reliance and has become part of the basic framework of a sizeable industry" (*Quill* 504 U.S. at 317)[9], the Court made clear in two separate instances that it has not extended the "bright-line" physical presence test to taxes other than sales and use tax. *See Quill* 504 U.S. at 314 ("we have not, in our review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes") and *Id.* at 317 ("although in our cases subsequent to *Bellas Hess* and concerning other types of taxes we have not adopted a similar bright-line, physical presence re-

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[9] The Court went on to note that "a bright-line rule in the area of sales and use taxes also encourages settled expectations and, in doing so, fosters investments by businesses and individuals. [footnote omitted]. Indeed, it is not unlikely that the mail-order industry's dramatic growth over the last quarter century is due in part to the bright-line exemption from state taxation created in Bellas Hess." *Quill*, 504 U.S. at 316.

quirement"). Further, the Court noted that "our Commerce Clause jurisprudence now favors more flexible balancing analyses."

In addition to the settled expectation of the mail order industry and principles of *stare decisis*, the Court in *Quill* also focused on the particular commercial burdens that result from the application of a state's sales and use tax collection duty and recognized the inherent burden a taxpayer could face "if similar obligations might be imposed by the Nation's 6,000-plus taxing jurisdictions" to collect a use tax. *Id.* at 313 n.6. There are, however, significant distinctions between the burdens resulting from collecting and remitting sales and use taxes and the payment obligation of an income-based tax. As one state court has observed:

> It is also evident from *Quill* that a sales and use tax can impose a special burden on interstate commerce beyond just the payment of money. Unlike an income tax, a sales and use tax can make the taxpayer an agent of the state, obligated to collect the tax from the consumer at the point of sale and then pay it over to the taxing entity. Whereas, a state income tax is usually paid only once a year, to one taxing jurisdiction and at one rate, a sales and use tax can be due periodically to more than one taxing jurisdiction within a state and at varying rates. *See Id.* at 313 n.6. Thus, collecting and paying a sales and use tax can impose additional burdens on commerce that the Supreme Court has repeatedly identified in prior opinions.

Kmart Properties, Inc. v. Taxation and Revenue Dep't, 139 N.M. 177, 185 (2001). *See also Tax Com-*

missioner of the State of West Virginia v. MBNA America Bank, N.A., 640 S.E. 2d 226, 233 (2006) (recognizing that the compliance burdens of sales and use tax collection and remission, including knowledge of a multitude of administrative regulations, extensive record-keeping, and frequent remission to the government, are greater than those of income-based taxes). Further, a commentator has noted that:

> Sales and use taxes and income taxes are functionally different and ultimately have different effects on taxed entities. Simply put, income taxes carry fewer administrative burdens for the taxpayer and pose less of a threat to interstate commerce. Unlike a sales or use tax, which is paid by every consumer, creative tax planners can exempt entire industries from income taxation. Accordingly, it is illogical for a court to apply the same analysis to the constitutionality of income taxes as it does to sales and use taxes."

Cory D. Olson, *Follow the Giraffe's Lead - Lanco, Inc. v. Director, Division of Taxation Gets Lost In The Quagmire That Is State Taxation*, 6 MINN J.L. SCI. & TECH. 789 (2005).

Accordingly, while *Quill* reaffirmed that physical presence is required in the context of a mail-order seller's sales and use tax obligation, there is neither a Supreme Court nor Massachusetts precedent that supports the proposition that physical presence is required to impose an income-based tax such as the FIET. In fact, Massachusetts has recognized the Supreme Court's careful limitation of *Quill* to the sales and use tax context: "[i]n *Quill*. . . the Court upheld a 'physical-presence requirement' before a State, con-

sistent with the commerce clause, could subject an out-of-State vendor to a use or sales tax. *The Court did not extend this rule to other types of tax.*" *Truck Renting*, 433 Mass. 733, 741 n.13 (2001) (emphasis added). *See also Aloha Freightways*, 428 Mass. at 423 n.4 ("Under Aloha's argument, the only State an interstate carrier could be found to have 'nexus' with would be one in which it maintains a base of operations. The requirement of 'nexus' does not provide such tax immunity to interstate carriers.").

With the physical-presence test of *Quill* properly limited to the sales and use tax context, the controlling authority in the instant appeals is *Complete Auto* and its query of whether the FIET is "applied to an activity with a substantial nexus with" Massachusetts. *Aloha Freightways*, 428 Mass. at 421 (quoting *Complete Auto*, 430 U.S. at 279). "Substantial nexus" comprises contacts of varied character and not merely those of a physical nature. For example, in a case virtually identical to the present appeals involving the taxation under a similar bank excise statute of an out-of-state credit card company with no physical presence in the taxing state, the Supreme Court of Appeals of West Virginia held that "[r]ather than a physical presence standard, this Court believes that a significant economic presence test is a better indicator of whether substantial nexus exists for Commerce Clause purposes." *MBNA America Bank*, 640 S.E.2d at 234.

The court in *MBNA America Bank* found that the taxpayer "continuously and systematically engaged in direct mail and telephone solicitation and promotion" in the taxing state and derived "significant gross receipts" from customers located in the state. *Id.* at 235-36. In light of these facts, the court, despite finding that the taxpayer had no real or tangi-

ble personal property or real estate located in the state, had "no trouble concluding that MBNA's systematic and continuous business activity in this State produced significant gross receipts attributable to its West Virginia customers which indicate a significant economic presence sufficient to meet the substantial nexus prong of *Complete Auto*." *Id.* at 236.

In the only other case involving the taxation of an out-of-state credit card company without physical presence cited by the parties, the Tennessee Court of Appeals appears to hold fast to the *Quill* physical-presence test, but a later case by that same court suggests otherwise. In *J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), the court ruled that Tennessee could not tax an out-of-state bank offering, among other services, credit-card lending and ATM services, because the bank "did not have a physical presence in Tennessee through its affiliates." *Id.* at 841.

However, several years later, the same Tennessee court seemed to retreat from a bright-line physical presence requirement for substantial nexus or to at least clarify its ruling in *J.C. Penney*. In *America Online, Inc. v. Johnson*, 2002 Tenn. App. LEXIS 555 (2002), the court, addressing whether an internet service provider with no property or employees in Tennessee could be subject to an income-based tax, stated that

> [t]his case is all about the nexus prong of the test. The chancellor held that the Supreme Court's decisions in this area, as interpreted by this court in *J.C. Penney* [citations omitted], has held fast to a bright-line test requiring an out-of-state company to have a 'physi-

> cal presence' in this state in order to have a substantial nexus with it. ***We think, however, that that reading of J.C. Penney would simply substitute "physical presence" for "nexus"*** [footnote omitted] ***as the first prong of the Complete Auto Transit test. As we read the cases, neither [the U.S. Supreme Court nor the Tennessee Court of Appeals] has made that suggestion...***
>
> We do not think that it is conclusive that AOL does not have offices or employees in the state or that it does not own or rent real property here. . . . ***Where. . .activities are "being conducted in the taxing state that substantially contribute to the taxpayer's ability to maintain operations in the taxing state," a substantial nexus does exist.***

America Online 2002 Tenn. App. LEXIS at *2, *3 (quoting *J.C. Penney*, 19 S.W. 3d at 841) (emphasis added).

Other state courts have also upheld the imposition of an income-based tax on out-of-state corporations with no in-state real or tangible personal property or employees. A year after the *Quill* decision, South Carolina became the first state to uphold an income-based tax solely on the presence of trademark assets within the taxing jurisdiction. *See Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993). The out-of-state taxpayer in *Geoffrey* held several valuable trademarks that it licensed to its parent for use in retail stores, including stores in the South Carolina, for a royalty fee of one percent of net sales. *Id.* at 15. The court held that "by licensing intangibles for use in this State and de-

riving income from their use here, Geoffrey ha[d] a 'substantial nexus' with South Carolina." *Id.* at 18. *See also Secretary, Department of Revenue v. Gap (Apparel), Inc.*, 886 S.2d 459, 462 (La. Ct. App. 2004) ("While Apparel may not have a physical presence in Louisiana, its intangible property clearly has a connection with Louisiana.... it is clear that the marks licensed by Apparel have been used in Louisiana in such a way as to become an integral part of the licensees' business in this state.").

In another case involving the imposition of an income-based tax on an out-of-state trademark holding company with no in-state tangible property or representatives, the New Mexico Court of Appeals held that *Quill* does not extend the physical presence requirement to income taxes, ruling that:

> The Commerce Clause analysis of New Mexico income tax is controlled, not by *Quill's* physical presence, but by the overarching substantial nexus test announced in *Complete Auto Transit*. . . .[T]he use of [the taxpayer's] marks within New Mexico's economic market, for the purpose of generating substantial income for the [the taxpayer], establishes a sufficient nexus between that income and the legitimate interests of the state and justifies the imposition of a state income tax.

Kmart, 139 N.M at 186.

North Carolina, in a case involving nine trademark holding companies, also adopted the reasoning of *Geoffrey*, finding that "under facts such as these where a wholly-owned subsidiary licenses trademarks to a related retail company operating stores located within North Carolina, there exists a sub-

stantial nexus with the State sufficient to satisfy the Commerce clause." *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187, 195 (N.C. Ct. App. 2004).

The *A&F Trademark* decision was cited approvingly in a recent New Jersey court decision that upheld an income-based tax on a foreign trademark holding company with "no physical presence in the state and deriv[ing] income from a New Jersey source pursuant only to a license agreement with another corporation that conducts a retail business" in the state. *See Lanco, Inc. v. Director, Division of Taxation*, 879 A.2d 1234, 1235 (N.J. Super. Ct. App. Div. 2005). The court held that "[w]e are satisfied that the physical presence requirement applicable to use and sales taxes is not applicable to income tax and that the New Jersey Business Corporation Tax may be constitutionally applied to income derived [ ] from licensing fees attributable to New Jersey." *Id.* at 1242. Quoting from the *A&F Trademark* opinion, the court declined to extend *Quill* beyond the sales and use tax context:

> The North Carolina Court of Appeals stated three reasons for declining to adopt the broader reading of *Quill* as requiring a physical presence for income tax purposes. . . . "First, the tone in the *Quill* opinion hardly indicates a sweeping endorsement of the bright-line test it preserved, and the Supreme Court's hesitancy to embrace the test certainly counsels against expansion of it.". . . The [United States Supreme] Court further observed the physical-presence test, though offset by the clarity of the rule, was "artificial at its edges.". . . In addition the Court twice noted that in other types of taxes, it had never articulated the same

> physical-presence requirement adopted in *Bellas Hess*. . . the Court's choice to abstain from rejecting the *Bellas Hess* rule for sales and use taxes fails to argue persuasively that the rule should, for lack of rejection, be augmented to cover other types of tax.

Lanco, 879 A.2d at 1239-40.

The Washington Court of Appeals, in a case involving the income-based taxation of an out-of-state automaker that claimed to have no physical presence in Washington, held that "[a]ny corporation that regularly exploits the markets of a state should be subject to its jurisdiction to impose an income tax even though not physically present." *General Motors Corp. v. City of Seattle*, 25 P.3d 1022, 1029 (Wash. Ct. App. 2001). The court held that the tax at issue was constitutional, finding that

> [t]he tax at issue here is neither a sales or use tax, nor is it a franchise tax. It is a business and occupation tax for the privilege of engaging in business within the City of Seattle. The automakers certainly exploit the market in the City, regardless of where they are physically located. We decline to extend *Quill's* physical presence requirement in this context.

Id. at 1029. *See also Couchot v. State Lottery Commission*, 659 N.E.2d 1225, 1230 (Ohio 1996) ("There is no indication in Quill that the Supreme Court will extend the physical-presence requirement to cases involving taxation measured by income derived from the state. . . . Thus, the physical-presence requirement of *Quill* is not applicable to the case sub judice"); *Borden Chemicals and Plastices, L.P. v. Zehnder*, 726 N.E.2d 73, 80 (Ill. App. Ct. 2000)

("Plaintiff argues that in *Quill*, the Supreme Court 'left open' the question of whether a physical presence is required in order to satisfy the substantial nexus requirement in other tax cases. We disagree.").

On the basis of the foregoing, the Board ruled, consistent with the overwhelming weight of authority from the Supreme Court and those jurisdictions that have addressed the question, that the physical-presence requirement in *Quill* is not applicable to an income-based excise such as the FIET. Rather, guided by the above precedents, the Board ruled that the Banks' deliberate and targeted exploitation of the Massachusetts economic market and its use of the commonwealth's governmental infrastructure and resources constitute "substantial nexus" under the *Complete Auto* test.

The Banks' derived substantial economic gain from the Massachusetts market through a sophisticated marketing campaign that targeted Massachusetts customers and by use of the Visa and MasterCard network, which included Massachusetts retailers and their "acquiring banks" as well as Massachusetts consumers armed with "Capital One"-branded credit cards. The customer's use of the Capital One cards provided the user with instant buying and borrowing power and informed merchants that the Banks were guaranteeing prompt payment for the goods or services purchased by the customers, since the Banks assumed all credit risk and paid the merchant its charges, less the "merchant discount" charged by the Banks and the acquiring banks. It was the financial resources and stability of the Banks, as represented by the Capital One logo on the credit cards, together with the Visa and MasterCard networks of which the Banks were a part, that en-

abled the transactions from which the Banks derived substantial revenue to occur. Accordingly, like the *Geoffrey*-line of cases, the use of Capital One's intangible property - the Capital One trademark on the cards - within the Massachusetts economic market to generate substantial revenue further supports the Board's ruling that there was substantial nexus. *See, e.g., Kmart*, 139 N.M at 186.

The Banks' expert witnesses, who offered opinions from an economic and policy perspective that the physical presence of a corporation should be required before an state may exact a tax, were unpersuasive. It is the policy of the Legislature as embodied in the language of the FIET, and the legal precedents of the Supreme Court, the Supreme Judicial Court and state courts of competent jurisdiction that govern the question of whether the FIET is constitutional and whether the Banks were appropriately assessed the FIET for the years at issue. As the Supreme Court has observed:

> Nothing can be less helpful than for courts to go beyond the extremely limited restrictions that the Constitution places upon the states and to inject themselves in a merely negative way into the delicate processes of fiscal policy-making. We must be on guard against imprisoning the taxing power of the states within formulas that are not compelled by the Constitution but merely represent judicial generalizations exceeding the concrete circumstances which they profess to summarize.

Wisconsin v. J.C. Penney, 311 U.S. 435, 445 (1940).

For all of the foregoing reasons, the Board ruled that the FIET is constitutional under the Commerce Clause.

III. THE FIET IS A REASONABLE EXCISE ON A COMMODITY

Massachusetts Constitution Part II, c. 1, § 1, Art. 4 provides in pertinent part that:

> full power and authority are given to the general court. . . to impose and levy reasonable duties and excises, upon any produce, goods, wares, merchandise, and commodities, whatsoever, brought into, produced, manufactured, or being within the same. . .

Accordingly, an excise must meet two requirements: it must be reasonable and it must be levied upon produce, goods, wares, merchandise or commodities.

An excise is unreasonable if it is "unjustly discriminatory, arbitrary, whimsical or irrational." *American Uniform Co. v. Commonwealth*, 237 Mass. 42, 45 (1921). "The court cannot declare a tax or excise illegal and void, as being unreasonable, unless it is unequal, or plainly and grossly oppressive, and contrary to common right." *Connecticut Mut. Life Ins. Co. v. Commonwealth*, 133 Mass. 161, 163 (1882). Wide discretion is given to the Legislature in determining what is subject to an excise, as well as its amount and the standard or measure to be adopted as its foundation. *Id.* The provision that an excise must be "reasonable" was not designed to give the judiciary the right to revise the Legislature's decisions in regard to the policy and expediency of an excise. *Id.*

The FIET is imposed uniformly on financial institutions engaged in business in Massachusetts.

Through their Massachusetts business activities, financial institutions such as the Banks avail themselves of the Commonwealth's laws, protections, and privileges, and thus the FIET is not unequal, plainly or grossly oppressive or contrary to common right. The FIET is not arbitrary or irrational, as it is directly related to the privileges that financial institutions receive from the right to engage in business and to sell their services in Massachusetts. *Greenfield Sav. Bank v. Commonwealth*, 211 Mass. 207, 210 (1912).

The FIET, which is based on net income apportioned to Massachusetts, is also reasonably calculated. *See Andover Sav. Bank* 387 Mass. at 236 ("[T]he value of transacting business as a savings bank or cooperative bank lies... in the benefits that are enjoyed by the depositors and borrowers."). The court held in *Andover Savings* the income-based portion of an excise was reasonable as "[i]t measures the value of the bank's investment function according to the returns that are realized for the benefit of its depositors. . . Greater precision in measuring the value of the privilege is not constitutionally required." *Id.*

The FIET also satisfies the constitutional requirement that an excise be levied upon produce, goods, wares, merchandise or commodities. *See Opinion of the Justices to the Governor*, 408 Mass. 1201, 1213 (1990). The FIET taxes the commodity of the right and privilege of doing business and the sale of financial services in the Commonwealth. *See Greenfield Sav. Bank*, 211 Mass. at 210.

"The power to determine what callings, franchises, or privileges, or, to use the language of the Constitution, 'commodities,' shall be subjected to an excise, and the amount of the excise belongs exclu-

sively to the Legislature." *Connecticut Mut. Life Ins. Co.*, 133 Mass. at 163. "The language of the Constitution of Massachusetts is general, and may well be held to authorize the laying of excises upon all such gainful employments and privileges as are created or may be regulated by law, and commonly have been considered legitimate subject of taxation in other States and countries." *Minot v. Winthrop*, 162 Mass 113, 122 (1894).

The term "'[c]ommodity'. . . includes the privilege and convenience of transacting a particular business; and, upon persons carrying on such business, it has never been questioned that the Legislature may levy an excise, or provide that a license must be obtained in order to transact it." *Commonwealth, by Commissioner of Sav. Banks v. Lancaster Sav. Bank*, 123 Mass. 493, 495 (1878). For purposes of the Massachusetts Constitution, a commodity "will perhaps embrace every thing which may be a subject of taxation," and, more specifically, it "has been applied by our legislature, from the earliest practice under the Constitution, to the privilege of using particular branches of business or employment." *President, Dirs., & Co. of the Portland Bank v. Apthorp*, 12 Mass. 252, 256 (1815).

The sale of services is a commodity and can be constitutionally taxed as an activity that may be regulated by Massachusetts, even if it is not in fact regulated. *Opinion of the Justices*, 408 Mass. at 1213 (citing *Minot*, 162 Mass. at 122). The word "commodity" is not limited to tangible personal property, and includes those benefits, privileges, and activities that may be regulated by the Commonwealth. *Id.* Therefore, the FIET, an excise upon the sale of financial services and the privilege to do business in Massachusetts, falls within the Legislature's authority un-

der Massachusetts Constitution Part II, c. 1, § 1, Art. 4.

The FIET clearly manifests the Legislature's intent to impose an excise on financial institutions as compensation for the convenience and privilege of conducting business, and falls within the parameters of the Massachusetts Constitution. The Banks have substantially benefited from their right to do business in Massachusetts, receiving almost $360 million in accounts receivable from Massachusetts customers during the years at issue. The Banks have used the Commonwealth's infrastructure and laws to facilitate transactions with Massachusetts merchants and customers, and participated in the Visa and MasterCard networks, which included acquiring banks in Massachusetts. They have also acquired revenue by charging fees to Massachusetts customers in exchange for financial services, and therefore a reasonable excise may fairly be imposed on them. The fees were "sources of emolument and profit, not strictly called property, but which are rather to be considered as the means of acquiring property, from which a reasonable revenue may be exacted by the legislature." *Portland Bank*, 12 Mass. at 255. In exchange for these privileges, the state has imposed a reasonable excise on the Banks.

The Banks have set forth no persuasive argument or evidence that the FIET was unreasonable or improperly imposed under the Massachusetts Constitution. The Banks have therefore failed to meet their burden of showing that the FIET was unconstitutional. *See Boston v. Keene Corp.*, 406 Mass. 301, 305 (1989) ("The party challenging the statute's constitutionality must demonstrate beyond a reasonable doubt . . . that there are no 'conceivable grounds' which could support its validity.").

IV. CONCLUSION

On the basis of the foregoing, the Board ruled that the FIET is constitutional under the Constitutions of both the United States and Massachusetts. The Banks each clearly fall within the plain terms of the FIET: as banks, they are "financial institutions" and they meet the statutory presumption of being "engaged in business" by conducting activities "with one hundred or more residents of the commonwealth," and received "in excess of five hundred thousand dollars in receipts attributable to sources within the commonwealth."

In fact, the number of Massachusetts residents carrying COB credit cards rose from slightly fewer than 200,000 to more than 460,000 during the years at issue and FSB's Massachusetts customers rose from less than 4,000 to more than 7,000 during that period. COB's receivables related to Massachusetts customers grew from $72,162,796 to $113,655,624 during the years at issue, while FSB's Massachusetts receivables grew from $11,457,826 to $16,588,914. These receivables attributable to Massachusetts customers resulted in income of over $154 million for COB and $8.8 million for FSB for the years at issue. These figures vastly exceed the statutory amounts.

Therefore, the Board ruled that the FIET is constitutional and validly imposed on the Banks for each of the tax years at issue. Accordingly, the Board issued decisions for the appellee in these appeals.

By: Frank J. Scharaffa
Commissioner

APPENDIX C

MASSACHUSETTS GENERAL LAWS
PART I. ADMINISTRATION OF THE GOVERNMENT

TITLE IX. TAXATION

CHAPTER 63. TAXATION OF CORPORATIONS

TAXATION OF BANKS, TRUST COMPANIES, ETC.

Chapter 63: Section 1. Definitions

Section 1. When used in sections one to two A, inclusive, and section thirty-eight B, the following words shall, unless the context otherwise requires, have the following meaning:

"Billing address", the location indicated in the books and records of the taxpayer on the first day of the taxable year, or on such later date in the taxable year when the customer relationship began, as the address where any notice, statement or bill relating to a customer's account is mailed.

"Borrower or credit card holder located in this commonwealth", (a) a borrower, other than a credit card holder, that is engaged in a trade or business which maintains its commercial domicile in this commonwealth; or (b) a borrower that is not engaged in a trade or business or a credit card holder whose billing address is in this commonwealth.

"Code", the Internal Revenue Code of the United States, as amended and in effect for the taxable year, unless otherwise provided.

"Commercial domicile", (a) the headquarters of the trade or business, that is, the place from which the trade or business is principally managed and directed; or (b) if a taxpayer is organized under the laws of a foreign country, or of the Commonwealth of Puerto Rico, or any territory or possession of the United States, such taxpayer's commercial domicile shall be deemed to be the state of the United States or the District of Columbia from which such taxpayer's trade or business in the United States is principally managed and directed. It shall be presumed, subject to rebuttal, that the location from which the taxpayer's trade or business is principally managed and directed is the state of the United States or the District of Columbia to which the greatest number of employees are regularly connected or out of which they are working, irrespective of where the services of such employees are performed, as of the last day of the taxable year.

"Compensation", wages, salaries, commissions and any other form of remuneration paid to employees for personal services that are included in such employee's gross income under the Internal Revenue Code. In the case of employees not subject to the Internal Revenue Code, such as those employed in foreign countries, the determination of whether such payments would constitute gross income to such employees under the Internal Revenue Code shall be made as though such employees were subject to the Internal Revenue Code.

"Credit card", credit, travel or entertainment card.

"Credit card issuer's reimbursement fee", the fee a taxpayer receives from a merchant's bank because one of the persons to whom the taxpayer has issued a credit card has charged merchandise or services to the credit card.

"Employee", with respect to a particular taxpayer, any individual who, under the usual common-law rules applicable in determining the employer-employee relationship, has the status of an employee of that taxpayer.

"Engaged in business in the commonwealth", (a) having a business location in the commonwealth; (b) having employees, representatives or independent contractors conducting business activities on its behalf in the commonwealth; (c) maintaining, renting or owning any tangible or real property in the commonwealth; (d) regularly performing services in the commonwealth; (e) regularly engaging in transactions with customers in the commonwealth that involve intangible property and result in income flowing to the taxpayer from residents of the commonwealth; (f) regularly receiving interest income from loans secured by tangible personal or real property located in the commonwealth; or (g) regularly soliciting and receiving deposits from customers in the commonwealth. With respect to the activities described in clauses (d) to (g), inclusive, activities shall be presumed, subject to rebuttal, to be conducted on a regular basis within the commonwealth, if any of such activities are conducted with one hundred or more residents of the commonwealth during any taxable year or if the taxpayer has ten million dollars or more of assets attributable to sources within the commonwealth, or has in excess of five hundred thousand dollars in receipts attributable to sources within the commonwealth.

[Definition of "Financial institution" effective until July 3, 2008. For text effective July 3, 2008, see below.]

"Financial institution", (a) any bank, banking association, trust company, federal or state savings and loan association, including all banks for cooperatives organized under the United States Farm Credit Act of 1933, whether of issue or not, existing by authority of the United States, or any state, or a foreign country, or any law of the commonwealth; (b) any other institution, association or entity, the deposits or accounts of which are insured under the Federal Deposit Insurance Act or by the Federal Deposit Insurance Corporation, any institution, association or entity, which is a member of a federal Home Loan Bank, excluding corporations described in section 1 of chapter 171, any other bank or thrift institution incorporated or organized under the laws of a state which is engaged in the business of receiving deposits, any corporation organized under the provisions of 12 USC 611-631 and 12 USC 3101; (c) any corporation subject to chapter 167A, or registered under the Federal Bank Holding Company Act of 1956, or registered as a savings and loan holding company under federal law, but excluding a diversified savings and loan holding company unless it satisfies the definition of a financial institution elsewhere herein, including any subsidiary which participates in the filing of a consolidated return of income to the federal government; (d) any corporation subject to supervision by the division of banks including but not limited to corporations described in section 24 of chapter 93, sections 96 to 104, inclusive, or section 114C of chapter 140; section 38 of chapter 167; section 5 of chapter 167B; chapter 169A; chapter 255B; chapter 255C; chapter 255D; and chapter 255E; or (e) any

other corporation organized under the laws of the United States, the commonwealth or any other state or a foreign country which, in substantial competition with financial institutions as defined in any or all of clauses (a) to (d), inclusive, derives more than 50 per cent of its gross income, excluding nonrecurring, extraordinary items, from loan origination, from lending activities, including discounting obligations, or from credit card activities; but, corporations described in section 1 of chapter 171 shall be excluded from the definition of financial institution.

[Definition of "Financial institution" as amended by 2008, 173, Sec. 28 effective July 3, 2008 for tax years beginning on or after January 1, 2009. See 2008, 173, Sec. 101. For text effective until July 3, 2008, see above.]

"Financial institution", (a) any bank, banking association, trust company, federal or state savings and loan association, including all banks for cooperatives organized under the United States Farm Credit Act of 1933, whether of issue or not, existing by authority of the United States, or any state, or a foreign country, or any law of the commonwealth; (b) any other institution, association or entity, the deposits or accounts of which are insured under the Federal Deposit Insurance Act or by the Federal Deposit Insurance Corporation, any institution, association or entity, which is a member of a federal Home Loan Bank, excluding corporations described in section 1 of chapter 171, any other bank or thrift institution incorporated or organized under the laws of a state which is engaged in the business of receiving deposits, any corporation organized under the provisions of 12 USC 611-631 and 12 USC 3101; (c) any corporation subject to chapter 167A, or registered under the Federal Bank Holding Company Act of 1956, or reg-

istered as a savings and loan holding company under federal law, but excluding a diversified savings and loan holding company unless it satisfies the definition of a financial institution elsewhere herein, including any subsidiary which participates in the filing of a consolidated return of income to the federal government; (d) any corporation subject to supervision by the division of banks including but not limited to corporations described in section 24 of chapter 93, sections 96 to 104, inclusive, or section 114C of chapter 140; section 38 of chapter 167; section 5 of chapter 167B; chapter 169A; chapter 255B; chapter 255C; chapter 255D; and chapter 255E; or (e) any other corporation organized under the laws of the United States, the commonwealth or any other state or a foreign country which, in substantial competition with financial institutions as defined in any or all of clauses (a) to (d), inclusive, derives more than 50 per cent of its gross income, excluding nonrecurring, extraordinary items, from loan origination, from lending activities, including discounting obligations, or from credit card activities; but, corporations described in section 1 of chapter 171 shall be excluded from the definition of financial institution. The term "corporation" as used in this definition shall mean any corporation, or any "other entity" as defined in section 1.40 of chapter 156D, whether the corporation or other entity may be formed, organized, or operated in or under the laws of the commonwealth or any other jurisdiction, that is classified for the taxable year as a corporation for federal income tax purposes.

"Gross income", gross income as defined under the provisions of the Internal Revenue Code, as amended and in effect for the taxable year, plus the

interest from bonds, notes and evidences of indebtedness of any state, including this commonwealth.

"Gross rents", the actual sum of money or other consideration payable for the use or possession of property. "Gross rents" shall include, but not be limited to:

(a) any amount payable for the use or possession of real property or tangible property whether designated as a fixed sum of money or as a percentage of receipts, profits or otherwise;

(b) any amount payable as additional rent or in lieu of rent, such as interest, taxes, insurance, repairs or any other amount required to be paid by the terms of a lease or other arrangement; and

(c) a proportionate part of the cost of any improvement to real property made by or on behalf of the taxpayer which reverts to the owner or lessor upon termination of a lease or other arrangement. The amount to be included in gross rents shall be the amount of amortization or depreciation allowed in computing the taxable income base for the taxable year; provided, however, where a building is erected on leased land by or on behalf of the taxpayer, the value of the land shall be determined by multiplying the gross rent by eight and the value of the building shall be determined in the same manner as if owned by the taxpayer.

(d) the following shall not be included in the term "gross rents":

(i) reasonable amounts payable as separate charges for water, steam, and electric service furnished by the lessor;

(ii) reasonable amounts payable as service charges for janitorial services furnished by the lessor;

(iii) reasonable amounts payable for storage, provided such amounts are payable for space not designated and not under the control of the taxpayer; and

(iv) that portion of any rental payment which is applicable to the space subleased from the taxpayer and not used by it.

"Loan", any extension of credit resulting from direct negotiations between the taxpayer and its customer, or the purchase, in whole or in part, of such extension of credit from another. Loans include participations, syndications and leases treated as loans for federal income tax purposes. Loans shall not include: properties treated as loans under section 595 of the Internal Revenue Code; futures or forward contracts; options; notional principal contracts such as swaps; credit card receivables, including purchased credit card relationships; non-interest bearing balances due from depository institutions; cash items in the process of collection; federal funds sold; securities purchased under agreement to resell; assets held in a trading account; securities; interests in a REMIC as defined in section 860D of the Internal Revenue Code, or other mortgage-backed or asset-backed security; and other similar items.

"Loan secured by real property", a loan in which fifty percent or more of the aggregate value of the collateral, when valued at fair market value as of the time the original loan was incurred, was real property.

"Merchant discount", the fee or negotiated discount charged to a merchant by the taxpayer for the privilege of participating in a program whereby a

credit card is accepted in payment for the merchandise or services sold to the card holder.

"Net income", gross income, other than ninety-five percent of dividends received in any taxable year beginning on or after January first, nineteen hundred and ninety-nine from or on account of the ownership of any class of stock if the financial institution owns fifteen percent or more of the voting stock of the institution paying the dividend, less the deductions, but not the credits allowable under the provisions of the Internal Revenue Code, as amended and in effect for the taxable year. The term "dividends received' shall be treated in the same manner as under the Code, as amended and in effect for the taxable year. The term "dividends received", as it relates to distribution from a real estate investment trust, as provided in sections 856 to 859, inclusive, of the Code, shall be treated in the same manner as under the Code, as amended and in effect for the taxable year. For purposes of this section, any dividend received directly or indirectly from the real estate investment trust shall not be treated as a dividend. Any dividend received directly or indirectly from a regulated investment company, as provided in sections 851 to 855, inclusive, of the Code, shall not be included as part of the dividends received deduction otherwise available under this section. For taxable years beginning on or after January first, nineteen hundred and ninety-nine, the provisions of section two hundred and ninety-one of said Code shall not apply; and the provisions of section one hundred and seventy-one (a)(2) and two hundred and sixty-five of said Code shall only apply to the extent that the income to which the deductions relate is excludable from gross income. Deductions with respect to

the following items, however, shall not be allowed except as otherwise provided:

(a) dividends received, except as otherwise provided;

(b) losses sustained in other taxable years;

(c) taxes on or measured by income, franchise taxes measured by net income, franchise taxes for the privilege of doing business and capital stock taxes imposed by a state;

(d) the deduction allowed by section 168(k) of the Code; or

(e) the deduction allowed by section 199 of the Code.

"Participation", an extension of credit in which an undivided ownership interest is held on a pro rata basis in a single loan or pool of loans and related collateral. In a loan participation, the creditor originator initially makes the loan and then subsequently resells all or a portion of it to other lenders. The participation may or may not be known to the borrower.

"Person", an individual, estate, trust, partnership, corporation and any other business entity.

"Principal base of operations", with respect to transportation property means the place of more or less permanent nature from which said property is primarily directed or controlled. With respect to an employee, the "principal base of operations" means the place of more or less permanent nature from which the employee primarily (1) starts his work and to which he customarily returns in order to receive instructions from his employer or (2) (if (1) is not applicable) communicates with his customers or other persons, or (3) (if (1) and (2) are both not applicable)

performs any other functions necessary to the exercise of his trade or profession.

"Real property owned" and "tangible personal property owned", real and tangible personal property respectively, (1) on which the taxpayer may claim depreciation for federal income tax purposes, or (2) property to which the taxpayer holds legal title and on which no other person may claim depreciation for federal income tax purposes, or could claim depreciation if subject to federal income tax. Real and tangible personal property do not include coin, currency, or property acquired in lieu of or pursuant to a foreclosure.

"Regular place of business", an office at which the taxpayer carries on its business in a regular and systematic manner and which is consistently maintained, occupied and used by employees of the taxpayer.

"State", a state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States; any foreign country; or a political subdivision of any of the foregoing.

"Syndication", an extension of credit in which two or more persons fund and each person is at risk only up to a specified percentage of the total extension of credit or up to a specified dollar amount.

"Taxable", (a) that a taxpayer is subject in another state to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, a corporate stock tax, including a bank shares tax, a single business tax, or an earned surplus tax, or any tax which is imposed upon or measured by net income; or (b) that another state has jurisdiction to subject the taxpayer to any

of such taxes regardless of whether, in fact, the state does or does not.

"Taxable year", any fiscal or calendar year or period for which the taxpayer is required to make a return to the federal government; or the period for which a return is made by the taxpayer, if a return is made (1) for a period less than twelve months, or (2) for a period for which no return to the federal government is required.

"Taxpayer", a financial institution engaged in business in the commonwealth.

"Transportation property", vehicles and vessels capable of moving under their own power, including, but not limited to, aircraft, trains, water vessels and motor vehicles, as well as any equipment or containers attached to such property, such as rolling stock, barges, trailers or the like.

APPENDIX D

Massachusetts General Laws
PART I. ADMINISTRATION OF THE GOVERNMENT

TITLE IX. TAXATION

CHAPTER 63. TAXATION OF CORPORATIONS

TAXATION OF BANKS, TRUST COMPANIES, ETC.

Chapter 63: Section 2. Financial institutions; excise rate

[Subsection (a) effective until July 3, 2008. For text effective July 3, 2008, see below.]

Section 2. (a) Except as provided in subsection (b), every financial institution engaged in business in the commonwealth shall pay, on account of each taxable year, an excise measured by its net income determined to be taxable under section two A at the following rate: taxable years beginning on or after January first, nineteen hundred and ninety-five but before January first, nineteen hundred and ninety-six, twelve and thirteen hundredths percent; on or after January first, nineteen hundred and ninety-six but before January first, nineteen hundred and ninety-seven, eleven and seventy-two hundredths percent; on or after January first, nineteen hundred and ninety-seven but before January first, nineteen hundred and ninety-eight, eleven and thirty-two hundredths percent; on or after January first, nine-

teen hundred and ninety-eight but before January first, nineteen hundred and ninety-nine, ten and ninety-one hundredths percent; on or after January first, nineteen hundred and ninety-nine, ten and one-half percent; provided, however, that the excise imposed hereunder shall be no less than four hundred and fifty-six dollars.

[Subsection (a) as amended by 2008, 173, Sec. 29 effective July 3, 2008 for tax years beginning on or after January 1, 2009. See 2008, 173, Sec. 101. For text effective until July 3, 2008, see above.]

(a) Except as provided in subsections (b) and (d), every financial institution engaged in business in the commonwealth shall pay, on account of each taxable year, an excise measured by its net income determined to be taxable under section two A at the following rate: taxable years beginning on or after January first, nineteen hundred and ninety-five but before January first, nineteen hundred and ninety-six, twelve and thirteen hundredths percent; on or after January first, nineteen hundred and ninety-six but before January first, nineteen hundred and ninety-seven, eleven and seventy-two hundredths percent; on or after January first, nineteen hundred and ninety-seven but before January first, nineteen hundred and ninety-eight, eleven and thirty-two hundredths percent; on or after January first, nineteen hundred and ninety-eight but before January first, nineteen hundred and ninety-nine, ten and ninety-one hundredths percent; on or after January first, nineteen hundred and ninety-nine, ten and one-half percent; provided, however, that the excise imposed hereunder shall be no less than four hundred and fifty-six dollars.

[Subsection (b) effective until July 3, 2008. For text effective July 3, 2008, see below.]

(b) Any corporation taxable under this section and described in clause (c), (d) or (e) of the definition of "financial institution" in section one, but not described in clause (a) or (b) of said definition, shall pay on account of each taxable year beginning on or after January first, nineteen hundred and ninety-five an excise measured by its net income determined to be taxable under section two A at the rate of ten and one-half percent; provided, however, that the excise imposed hereunder shall be no less than four hundred and fifty-six dollars.

[Subsection (b) as amended by 2008, 173, Sec. 30 effective July 3, 2008 for tax years beginning on or after January 1, 2009. See 2008, 173, Sec. 101. For text effective until July 3, 2008, see above.]

(b) Any corporation taxable under this section shall pay an excise measured by its net income determined to be taxable under section 2A at the following rates:-- (i) for each taxable year beginning on or after January 1, 1995, but before January 1, 2010, 10.5 per cent; (ii) for each taxable year beginning on or after January 1, 2010, but before January 1, 2011, 10.0 per cent; (iii) for each taxable year beginning on or after January 1, 2011, but before January 1, 2012, 9.5 per cent; or (iv) for each taxable year beginning on or after January 1, 2012 and thereafter, 9.0 per cent; provided, however, that in no case shall the excise imposed under this section amount to less than $456.

(c) The commissioner is hereby authorized to adjust the net income of any taxpayer in accordance with the provisions of and the rules and regulations

under section 482 of the Internal Revenue Code, as amended from time to time.

[Subsection (d) added by 2008, 173, Sec. 31 effective July 3, 2008 for tax years beginning on or after January 1, 2009. See 2008, 173, Sec. 101.]

(d) Any financial institution that is an S corporation, as defined in section 1361 of the Code, shall not be subject to the tax provided in subsections (a) and (b) and shall instead be subject to the excise in section 2B.